APPENDIX

In the Supreme Court of the United States

OCTOBER TERM, 1978

No. 77-648

FEDERAL ENERGY REGULATORY COMMISSION, PETITIONER

v.

PENNZOIL PRODUCING COMPANY, ET AL.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

PETITION FOR A WRIT OF CERTIORARI FILED
November 3, 1977
CERTIORARI GRANTED JUNE 12, 1978

Supreme Court of the United States

OCTOBER TERM, 1978

No. 77-648

FEDERAL ENERGY REGULATORY COMMISSION, PETITIONER
v.
PENNZOIL PRODUCING COMPANY, ET AL.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

TABLE OF CONTENTS

TABLE OF CONTENTS—Continued

TABLE OF CONTENTS—Continued

In the United States Court of Appeals for the Fifth Circuit

(Title omitted in printing)

Relevant Docket Entries

Opinion	June 6, 1977
Judgment	June 6, 1977
Order on rehearing	September 1, 1977

[260]

UNITED STATES OF AMERICA
FEDERAL POWER COMMISSION

PENNZOIL PRODUCING COMPANY

Docket No. RI 76-8

PENNZOIL PRODUCING COMPANY'S PETITION FOR AUTHORIZATION TO COLLECT INCREASED RATES BASED ON INCREASED ROYALTY PAYMENTS OR, IN THE ALTERNATIVE, TO ABANDON SALES OF ROYALTY VOLUMES, FOR WAIVER OF REGULATIONS, AND FOR EXPEDITION

I.

Pennzoil Producing Company (Pennzoil), pursuant to Sections 4 and 7 of the Natural Gas Act and the Commission's Regulations thereunder, petitions the Commission to:

a. Authorize Pennzoil to charge and collect increased rates to reflect increased royalty payments resulting from settlement of pending litigation regarding gas covered by its FPC Gas Rate Schedule No. 234, or, in the alternative, authorize Pennzoil to abandon the sale of one-eighth (1/8) of such gas, effective January 1, 1974 but in no event later than October 1, 1975;

b. Waive Sections 154.93 and 154.105 of its Regulations and Section 2.56h of its General Policy and Interpretations;

c. Provide a shortened notice period;

d. Provide abbreviated or accelerated procedures, including, if a formal hearing is set, omission of the intermediate decision or setting of a date certain for any intermediate decision.

In support hereof, Pennzoil states as follows:

*   *   *   *

[261]

III

Pennzoil sells gas produced from the Gibson Field, Terrebonne Parish, Louisiana, to United Gas Pipe Line Company (United) under Pennzoil's Rate Schedule No. 234; the sale was certificated in Docket No. G-13633 on May 21, 1965 at which time Pennzoil's gas sales contract was designated as its FPC Gas Rate Schedule No. 75. Upon the execution and filing of a replacement contract, dated October 30, 1959, the Rate Schedule designation was changed to No. 234, as noted in the May 21, 1965 order in Docket No. G-13633. A portion of the gas is produced from acreage covered by a 1934 lease (the 1934 Lease) from F. B. Williams Cypress Company, Limited (now Williams, Inc.) to Shell Petroleum Corporation (now Shell Oil Company); a portion of the acreage was subleased by Shell Oil Company (Shell) to Union Producing Company (Pennzoil's predecessor) by instrument dated December 29, 1942.

The 1934 Lease provides for royalty on the gas production thereunder equal to one-eighth (1/8) "of the value thereof, calculated at the market rate prevailing at the well." The price Pennzoil may collect from United for this gas is regulated by this Commission.

However, by letters dated June 7, 1973 and March 27, 1974, Williams, Inc., *et al.* (Williams) demanded payment of royalty on this gas based upon so-called market values substantially above the price the Commission allows Pennzoil to collect from United and, therefore, above the price on which royalty is computed. In addition, by letter dated June 5, 1974, Williams declared the 1934 Lease terminated because of Pennzoil's alleged failure to pay the royalty which Williams claimed.

[262]

Pennzoil was unable to resolve the matter and, in order to protect its rights and interests, on May 24, 1974, Pennzoil and Shell (against which Williams made similar demand) filed a petition against Williams in the Civil District Court in the Parish of Orleans, Louisiana (*Shell Oil Company and Pennzoil Producing Company* v. *Williams, Inc., et al.*, Dkt. No. 573 591), asking issuance of a judgment declaring that Shell and Pennzoil are paying the appropriate royalty. By reconventional demand, Williams requested the Court to order, *inter alia,* cancellation of the 1934 Lease effective June 5, 1974, an accounting for, and payment of the value of, all minerals produced under the 1934 Lease since June 5, 1974, payment of $1,055,204.62 in "underpaid" royalties for the period through May 31, 1974, and payment of damages and attorneys' fees. The "underpayment" of royalties was calculated on the basis of an increasing market value of gas up to 70¢ per Mcf for the period from November 1973 through May 1974. Subsequently, Williams has amended its reconventional demand to cover the period from June 1, 1974 through April 30, 1975, alleging additional underpayments of royalties by Pennzoil of $1,989,222.91, based on an alleged market value of gas of $1.30 per Mcf from June 1, 1974 through December 31, 1974, and $1.40 per Mcf from January 1, 1975 through April 30, 1975.

IV.

After protracted negotiations, Pennzoil and Williams reached a settlement designed to permit Williams a higher royalty and to permit Pennzoil to retain the leases and sell the gas to United and the interstate market. That agreement is embodied in a document dated June 18, 1975 (the "Settlement Agreement"), a copy of which is attached

hereto as Exhibit A. The Settlement Agreement provides that Pennzoil will request this Commission to approve either:

1. Abandonment of the royalty share of the gas to Williams, or

2. Payment of a negotiated royalty equal to one-eighth (1/8) of the total of (a) the higher of (i) the royalty base rate or (ii) the base alternative rate, (b) 7¢ per Mcf (the current amount of the Louisiana severance tax, and (c) any Btu adjustments for gas containing more or less than 1000 Btu's per cubic foot, and the passthrough of such amount to United.

The base royalty rate is 78¢ per Mcf for 1975 and will increase 1.5¢ per Mcf each January 1 beginning January 1, 1976.

[263]

The base alternative rate is 150% of the highest area or national rate or, in the event of deregulation of gas sales, is the average of the three highest prices in producer sale for resale contracts in the South Louisiana Area.

Pursuant to the Settlement Agreement, Pennzoil requests the Commission to issue its approval effective January 1, 1974.

In addition, the Settlement Agreement defines the "Date of Final Order" as the first day on which a Commission order containing the requested authorization may first be appealed, and provides that the authorized procedure will be implemented on the Date of Final Order. In addition:

a. If abandonment authorization is granted, any royalty gas not delivered to Williams between the effective date of the Commission's order and the Date of Final Order will be delivered to Williams as soon as practicable, but such "make-up" deliveries must be

completed in not less than one-half of the time between the effective date of the Commission's order and the Date of Final Order.

b. Pennzoil is required within thirty days after the Date of Final Order to remit to Williams the sum of:

(i) the royalty which would have been paid on volumes delivered during 1974 had Pennzoil's sale price been 45¢ per Mcf, less the royalty actually paid, to the extent Pennzoil is allowed to recover such amounts from United, plus

(ii) if the Commission approves Pennzoil's payment of the higher royalty to Williams and recovery thereof from United, the royalty agreed upon for 1975 for volumes delivered during the period beginning on the effective date of the Commission's order (but not earlier than January 1, 1975) or October 1, 1975, whichever occurs first, and ending on the Date of Final Order.

Finally, the Settlement Agreement provides that if the Commission fails to issue acceptable authorization on or before February 1, 1976, either party may terminate the Settlement Agreement.

• • • •

[Text of Settlement Agreement appears both at R.268 and R.293 and is reproduced in this appendix at page 15.]

[285]

UNITED STATES OF AMERICA
FEDERAL POWER COMMISSION

SHELL OIL COMPANY

Docket No. RI76-10

PETITION BY SHELL OIL COMPANY FOR SPECIAL RELIEF AUTHORIZING COLLECTION OF RATES ABOVE APPLICABLE AREA OR NATIONAL RATE LEVELS BASED ON INCREASED ROYALTY PAYMENTS, OR IN THE ALTERNATIVE, TO ABANDON SALES OF ROYALTY VOLUMES, FOR WAIVER OF REGULATIONS, AND FOR EXPEDITION

Shell Oil Company (Shell), pursuant to Section 1.7 of the Commission's Rules of Practice and Procedure and Sections 4 and 7 of the Natural Gas Act and the Rules and Regulations thereunder, respectfully petitions this Commission to:

(a) Authorize Shell to charge and collect from United Gas Pipe Line Company (United) increased rates to reflect increased royalty payments resulting from settlement of pending litigation with respect to certain gas sold by Shell to United pursuant to Shell's FPC Gas Rate Schedule No. 202, or, in the alternative, authorize Shell to abandon the sale of one-eighth of such gas, effective January 1, 1974, but in no event later than October 1, 1975;

(b) Waive Sections 154.93, 154.98, and 154.105 of the Commission's Regulations and Section 2.56a of its General Policy and Interpretations; and

(c) Provide shortened procedures by omitting the intermediate decision procedure, if a formal hearing is set, and by expediting these proceedings.

In support of its Petition, Shell respectfully shows as follows:

* * * *

[286]

Shell sells gas produced from the Gibson Field, Terrebonne Parish, Louisiana, to United under Shell's FPC Rate Schedule No. 202. This sale was originally certificated in Docket No. G-5037 on May 28, 1956 at which time Shell's gas sales contract was designated as FPC Gas Rate Schedule No. 50. Upon the execution and filing of a replacement contract, dated May 1, 1959, the rate schedule designation was changed to No. 202, as noted in the Commission's Order dated June 11, 1959 in Docket No. G-18697 and the Commission's letter dated July 6, 1959.

A portion of the gas sold to United is produced from acreage covered by Mineral Lease dated August 29, 1934 (the 1934 lease) from F. B. Williams Cypress Company, Limited (now Williams, Inc.), to Shell Petroleum Corporation (now Shell) and by Mineral Lease dated July 24, 1952 (the 1952 lease) from Williams, Inc. to certain parties (which lease was assigned to Shell on January 24, 1955). A portion of the acreage covered by the 1934 lease was subleased to Union Producing Company (now Pennzoil Producing Company) on December 29, 1942. Certain portions of the 1934 lease have been unitized and are hereinafter referred to as "Unitized Acreage".

The 1934 lease provides for royalty of the gas production thereunder equal to one-eighth "of the value thereof, calculated at the market rate prevailing at the well", and the 1952 lease provides for royalty on the gas production thereunder equal to one-fourth "of the value thereof, calculated at the market price prevailing at the well".

[287]

On June 7, 1973, and again on March 27, 1974, Williams, Inc. demanded payment by Shell for gas produced from acreage covered by these leases based on the so-called "market value" clauses contained therein. Further, on June 5, 1974, Williams, Inc. declared both the 1934 lease and the 1952 lease terminated because of Shell's alleged failure to pay the royalty claimed by Williams, Inc.

In order to protect its legal rights and interests in these leases, Shell and Pennzoil Producing (against whom similar demands were made by Williams, Inc.) filed a petition on May 24, 1974 in the Civil District Court in the Parish of Orleans, Louisiana (*Shell Oil Company and Pennzoil Producing Company* v. *Williams, Inc., et al.*, Docket No. 573-591) asking issuance of a judgment declaring that Shell and Pennzoil Producing are paying the appropriate royalty. By reconventional demand, Williams, Inc., requested the Court to order cancellation of both the 1934 lease and the 1952 lease effective June 5, 1974 and an accounting for, and payment based on the value of, all minerals produced under such leases since June 5, 1974.

Shell and Williams, Inc. have entered into a Settlement Agreement dated June 18, 1975 (attached hereto as Appendix A) which will permit Shell to retain both the 1934 lease and the 1952 lease and continue to sell natural gas to United for the interstate market upon the payment of higher royalties to Williams, Inc. The Settlement Agreement provides that Shell will make such applications to the Federal Power Commission as may be necessary to obtain authorization for the following:

(A) Payment by Shell of royalty on each Mcf produced and sold from Unitized Acreage and under the 1952 lease, equal to one-eighth in the case of the Unit-

ized Acreage and one-fourth in the case of the 1952 lease, of the total of:

(1) the higher of

(a) the base royalty rate, or

(b) the base alternative rate, plus

(2) 7¢ or the full amount of the Louisiana severance tax, which amount is to be

[288]

increased as the severance tax of the State of Louisiana is increased, plus

(3) the full amount of federal taxes imposed upon Williams, Inc., plus

(4) any upward or downward adjustment for Btu content of the gas containing more or less than 1,000 Btu per cubic foot, and

pass through to United of the portion of such total which exceeds current royalty payments by Shell to Williams, Inc.

In connection with the above, "base royalty rate" is 78¢/Mcf as of January 1, 1975, increasing 1.5¢/Mcf each January 1st beginning January 1, 1976. "Base alternative rate" is 150 percent of the highest area or national rate permitted or, in the case of deregulation of interstate gas sales, is the average of the three highest prices provided in sales for resale in the South Louisiana area; or

(B) Abandonment of that share of the gas sold under said leases which is attributable to Williams, Inc., royalty interests.

In addition, the Settlement Agreement provides for Shell to deliver royalty gas to Williams, Inc., in the event abandonment authorization is granted pursuant to (B) above, and further to pay Williams, Inc. the sum of the royalty which would have been paid during 1974 if Shell's sales

price during such period had been 45¢/Mcf, less royalty actually paid, plue the royalty due if the Commission approves (A) above, all as more fully spelled out in Article II of the Settlement Agreement attached hereto as Appendix A.

Shell requests that the Commission issue its approval as requested herein effective January 1, 1974. If the Commission fails to issue its Order authorizing either (A) or (B) above, or other acceptable authorization before February 1, 1976, either party may terminate the Settlement Agreement.

[289]

IV.

By Letter Agreement dated June 23, 1975 (Appendix B hereto) Shell and United have amended the Gas Purchase Contract dated May 1, 1959, covering the gas sold from the Gibson Field to provide for payment by United to Shell of any increased royalty amounts authorized by Order of this Commission. In the event the FPC authorizes abandonment of the interest attributable to Williams, Inc., United will amend the May 1, 1959 Contract so as to reflect release of that gas from the Contract. This Letter Agreement is also being filed concurrently herewith as a supplement to Shell's Rate Schedule No. 202.

Promptly upon Commission authorization of (A) above Shell will file a notice of rate change pursuant to Section 154.94 of the Commission's Regulations reflecting the increased rate for the volumes of gas sold thereafter, and also containing a surcharge for royalty on volumes delivered between January 1, 1974 and Date of Final Order, at the settlement rate specified in the Settlement Agreement.

V.

Shell is a natural gas company under the Natural Gas Act and the rates collected for sales of natural gas in interstate commerce for resale are subject to the jurisdiction of this Commission. In this respect, the rates collected for the sale of gas to United pursuant to FPC Rate Schedule No. 202 are governed by the rates established by this Commission in the Southern Louisiana Area Rate Case[1] and the National Rate Case[2]. The increased royalties payable pursuant to the Settlement Agreement render the rates authorized by Opinion Nos. 598 and

[290]

699-H inappropriate. The U.S. Court of Appeals for the Fifth Circuit specifically authorized the relief sought by this Petition by stating:

> "If, as subsequent events develop, the producers are put in a bind by their royalty obligations, they may certainly petition FPC for individualized relief."[3]

and

> "If the royalty obligations are such as to make the rates established by Op:598, and approved by us here, confiscatory or otherwise inappropriate, those producers who are materially affected will certainly have recourse to the administrative process."[4]

In the above referred to litigation, Williams, Inc. is vigorously seeking cancellation of the 1934 and 1952 leases on

[1] Opinion Nos. 598 and 598-A issued July 16, 1971, and September 9, 1971, respectively, 46 F.P.C. 86 and ... F.P.C. ...; affirmed in *Placid Oil Co., et al.* v. *F.P.C.*, 483 F.2d 880 (5th Cir. 1973); affirmed *Mobil Oil Corp., et al.* v. *F.P.C.*, 417 U.S. 283 (1974).

[2] Opinion No. 699 issued June 21, 1974, ... F.P.C. ...; appeal pending *Shell Oil Company, et al.*, v. *F.P.C.*, Nos. 74-3330, *et al.*

[3] *Placid Oil Co., et al.* v. *F.P.C.*, 483 F.2d 880, at 911.

[4] *Id.*

the basis of failure by Shell to pay royalty on so-called "market value". In the face of this litigation, the special relief requested by Shell herein, which would terminate this litigation if granted, is needed by Shell now in order to be effective. United is in a severe curtailment situation at this time and, as evidenced by Appendix B is willing to pay higher prices in order to keep this gas in its system. Based on these facts, Shell believes the public interest would best be served in this proceeding by United retaining the gas produced from these leases for the interstate market even if such gas is at a slightly higher price to compensate Shell for the increased royalties to be paid Williams, Inc. pursuant to the Settlement Agreement.

VI.

Shell requests the Commission to act on this Petition as quickly as possible by providing:

(1) a shortened notice period, and

[291]

(2) an abbreviated or accelerated hearing schedule, if this proceeding is set for formal hearing, including omission of the intermediate decision.

For the foregoing reasons, Shell respectfully requests the Commission to:

(1) authorize Shell to collect increased rates based upon payment of increased royalty, as more fully described herein, or, in the alternative, authorize abandonment of the royalty share of the gas, effective January 1, 1974, but in no event later than October 1, 1975;

(2) waive Sections 154.93, 154.98, and 154.105 of the Commission's Regulations and Section 2.56a of its General Policy and Interpretations; and

(3) provide shortened procedures as more fully described herein.

Respectfully submitted,

THOMAS G. JOHNSON
WILLIAM G. RIDDOCH
WILLIAM A. WOOD
Attorneys for
SHELL OIL COMPANY

By /s/ WILLIAM G. RIDDOCH
William G. Riddoch

July 16, 1975
Houston, Texas

• • • •

[293]

APPENDIX A

SETTLEMENT AGREEMENT

THIS AGREEMENT is made this 18th day of June, 1975, by and between Pennzoil Producing Company ("Producing"), Shell Oil Company ("Shell") (Producing and Shell being hereinafter jointly referred to as "Lessees") and Williams, Inc. and the remaining royalty owners listed on Annex A to this agreement (hereinafter sometimes collectively referred to as "Lessor").

WITNESSETH:

WHEREAS, by Mineral Lease dated August 29, 1934, F. B. Williams Cypress Company, Limited (now Williams, Inc.), granted certain mineral interests and rights to Shell Petroleum Corporation (now Shell Oil Company), (said Mineral Lease being hereinafter sometimes referred to as "1934 Lease");

WHEREAS, by instrument dated December 29, 1942, Shell subleased certain of its rights and interests to a portion of the acreage covered by the 1934 Lease to Union Producing Company (now Producing);

WHEREAS, certain portions of the acreage covered by the 1934 Lease have been unitized, such portions being herein referred to as "Unitized Acreage";

WHEREAS, by Mineral Lease dated July 24, 1952, Williams, Inc. granted certain mineral interests and rights to certain parties and those interests and rights were assigned to Shell on January 24, 1955 (said Mineral Lease being hereinafter sometimes referred to as "1952 Lease";

WHEREAS, the 1934 Lease provides for royalty of the gas production thereunder equal to one-eighth "of the value

thereof, calculated at the market rate prevailing at the well", and the 1952 Lease provides for

[294]

royalty on the gas production thereunder equal to one-fourth "of the value thereof, calculated at the market price prevailing at the well";

WHEREAS, Lessor has demanded payment of gas royalty amounts which it asserts were underpaid by Lessees under the 1934 Lease and the 1952 Lease for a period commencing October 1, 1971;

WHEREAS, in judicial proceedings Lessor has demanded cancellation and termination of the 1934 and 1952 leases due to the Lessor's assertion that the Lessees have failed to pay the proper royalties due under the leases;

WHEREAS, there is presently pending on the docket of the Civil District Court for the Parish of Orleans, State of Louisiana, civil litigation in which the rights and obligations of the parties concerning royalty payments under the aforesaid leases are being contested;

WHEREAS, Lessees have asserted that they have paid and are still paying the royalties which have been legally due; and

WHEREAS, the parties desire to avoid further disputes and to set at rest the issue in pending litigation.

NOW, THEREFORE, the parties agree as follows:

I.

Lessees agreed promptly to perfect such applications with the Federal Power Commission (hereinafter referred to as "FPC") as may be necessary to obtain FPC authorization for the following with respect to gas produced and sold from said Leases:

A. (Both (i) payment by Producing to Lessor of royalty on each Mcf of gas Producing produces and sells from Unitized Acreage, and payment by Shell of royalty on each Mcf it produces and sells from Unitized Acreage and under the 1952 Lease, equal to one-

[295]

eighth (1/8) in the case of Unitized Acreage and one-fourth (1/4) in the case of the 1952 Lease, of the total of (1), (2), (3) and (4) as follows:

(1) the higher of

(a) the "base royalty rate" as hereinafter defined, or

(b) the "base alternative rate" as hereinafter defined, plus

(2) 7¢ or the full amount of the Louisiana severance tax, which amount is to be increased as the severance tax of the State of Louisiana is increased, and plus

(3) the full amount of federal taxes imposed upon Lessor for the severance or production of such gas should such taxes be imposed, less any portion of such tax which may be specified by the FPC as being included in any rate which forms the basis of the base alternative rate; plus

(4) any adjustments for gas containing more or less than 1,000 Btu's per cubic foot utilizing the formula for Btu adjustments set out in FPC Opinion No. 699-H,

and (ii) receipt by Lessees from United Gas Pipe Line Company (hereinafter referred to as "United") of the portion of such total

[296]

which exceeds one-eighth (1/8) or one-fourth (1/4), as the case may be, of the total price (including all adjustments)

which Lessees would receive from United for the sale of such gas in the absence of this agreement and of such FPC authorization.

The following definitions shall apply to the above:

1. The "base royalty rate" shall be 78¢ per Mcf for 1975 and shall increase 1.5¢ per Mcf each January 1 beginning January 1, 1976.

2. The "base alternative rate" shall be 150% of the "highest rate" prescribed or permitted by the FPC (or by any successor Federal agency having authority to review or establish rates for natural gas flowing in interstate commerce) for natural gas flowing in interstate commerce from any area in the lower forty-eight states in which Producing or Shell are making interstate sales of natural gas; provided, however, that in determining such "highest rate," only those rates of general applicability, such as the "national rate" which are prescribed or permitted with respect to sales of gas at the wellhead shall be considered, and there shall be excluded from consideration any rates prescribed or permitted with respect to sales made pursuant to:

(i) contracts with small producers,

(ii) contracts for emergency sales,

[297]

(iii) contracts having a term of less than one year, and

(iv) contracts made in accordance with FPC Orders 455, 455-A and 455-B.

There also shall be excluded from consideration rates prescribed or permitted by the FPC:

(i) pursuant to petitions for special relief, excluding the Petition to be filed by lessees pursuant to this agreement, and other documents hereunder to be filed by Lessees,

(ii) under unilateral producer filings,

(iii) for liquefied natural gas in liquid or regasified states, and

(iv) for synthetic gas, even if it be defined as natural gas.

Such "highest rate" shall be determined consistent with the fifty cent (50¢) per Mcf base rate specified in FPC Opinion No. 699-H, or similar successor opinions, including all increases in that rate but excluding, for the determination of such base alternative rate, any adjustments for gathering allowance and production, severance and similar taxes, but adjusted to a pressure base of 15.025 psia, but as noted above the "base alternative rate" shall be 150% of the "highest rate."

3. On the date that the price of natural gas sold by Producers in interstate commerce for resale ceases to be subject to price

[298]

regulation by the FPC (or any successor agency), or to the extent such deregulation is applicable to the gas produced under the 1934 Lease or the 1952 Lease, whichever first occurs, the parties agree that the "base alternative rate" shall be determined only once for each calendar year and, when so determined, shall be effective hereunder for the entirety of such calendar year. In such case, the "base alternative rate" shall be equal to the average of the three highest wellhead rates provided in separate contracts for the sale of gas for resale, effectual on or before January 1 of the calendar year for which the base alternative rate is being determined for gas to be delivered in interstate commerce during such calendar year from the portion of the southern Louisiana area located within the state of Louisiana, as such area is defined in F.P.C. Opinion 546 (and Shell and Producing will each provide Lessor with satisfactory evidence of the price contained in the three highest contracts used by them in computing the "base alternative rate" and the price contained in their

own highest price contracts in such area); provided, however, in determining the average rate there shall be excluded from consideration any rates:

(i) prescribed in contracts having a term of less than one year, or

(ii) payable for liquefied natural gas in liquid or regasified state, or

[299]

(iii) payable for synthetic gas, even if it be defined as natural gas, or

(iv) set forth in contracts for direct sales from another pipeline.

In determining the three highest rates, appropriate adjustment shall be made to those three highest rates for contract variances, which adjustment shall include only:

(i) Btu,

(ii) pressure base,

(iii) gathering allowance (if delivery point is other than the wellhead),

(iv) compression allowances, and

(v) taxes;

in order that the base alternative rate shall be exclusive of any adjustments for such items. The amount of such adjustment shall be only to the extent ordinarily and customarily made in the gas industry, and the lessees shall provide lessor with copies of their calculations, if any, for such contract variances.

Such average rate shall be adjusted to a pressure base of 15.025 psia; or

B. Delivery by Lessees to Lessor of one-eighth (1/8) or one-fourth (1/4), as the case may be, of the gas attributable to Lessees' respective interests in the Unitized Acreage

and under the 1952 Lease, in kind, for use or sale by Lessor to any market.

[300]

C. Lessees agree to request the FPC to issue its order effective January 1, 1974.

II.

A. If the FPC authorizes the procedures described in A. or B. of Section I. hereof, or any other procedure acceptable to all parties hereto, then on the first day an FPC order containing such authorization may first be appealed (that is, by the filing of a notice of appeal with the United States Court of Appeals) under Section 19 of the Natural Gas Act, 15 U.S.C. § 717(r) (the Date of Final Order), the procedure which was so authorized by the FPC shall be implemented. Any gas not delivered in kind under subsection B. of Section I. between the effective date of such order and the Date of Final Order shall be delivered as soon as practicable, but any such "make-up" deliveries shall be completed during a period which shall not exceed one-half (1/2) of the time expired between the effective date of such order and the Date of Final Order.

B. In addition, within thirty (30) days after the Date of Final Order, Lessees shall remit to Lessor the sum of:

(a) the royalty which would have been paid on volumes delivered during 1974 had Lessees' sale price for such gas been 45¢ per Mcf, less the royalty which has in fact been paid but only to the extent the FPC permits Lessees to recover such amounts from United, plus

[301]

(b) (if the Commission approves Section I.A. hereof but not Section I.B.) the royalty specified in Section I.A. for the period commencing with the earlier of:

(i) the effective date of said order, but not earlier than January 1, 1975, or

(ii) October 1, 1975,

and ending on the Date of the Final Order.

Said sums together shall be deemed to constitute full and complete satisfaction of all claims for royalty on gas produced and sold by Lessees from the Unitized Acreage and under the 1952 Lease prior to the Date of Final Order.

III.

Upon acceptance of the FPC authorization described in the preceding Section II., the procedure so authorized shall amend the 1934 Lease and the 1952 Lease, effective on the effective date of such authorization or October 1, 1975, whichever occurs first, to provide that the procedure authorized by the FPC and accepted by the parties hereto shall constitute the sole agreements between such parties as to payment of gas royalties with respect to gas produced from the Unitized Acreage and under the 1952 Lease, subject to the restrictions of Section VIII.B. Further, neither Lessor nor any heirs, successors or assigns of Lessor shall make any claim or demand or bring any action to recover from Lessees or their successors or assigns any gas royalty on gas produced from Unitized Acreage or under the 1952 Lease prior to the effective date of said FPC order or October 1, 1975, whichever occurs first.

[302]

IV.

A. Within ten (10) days after the expiration and termination of all appeals, petitions for rehearings, or petitions for writ of certiorari with any court or the FPC, and the expiration and termination of all rights and time periods within which to file appeals petitions for rehearing, petitions for writs of certiorari, with any court or the FPC, of any person or party as to the FPC authorization described in the preceding Section II., and after the FPC authorization herein in all respects is absolutely final and non-appealable as to all parties or persons whatsoever, the parties hereto shall jointly move to dismiss, with prejudice, those claims pending between Lessor and Lessees in *Shell Oil Company & Pennzoil Producing Company* v. *Williams, Inc., et al.,* Docket No. 573-591 in the Civil District Court for the Parish of Orleans in the State of Louisiana; but such dismissal shall not take place prior to the initial payment or delivery of gas to Lessors under Section I hereof or prior to Lessees implementing the provisions of Section II hereof.

B. Within ten (10) days after execution of this Agreement, Lessors may amend their complaint to increase the stated value of gas and the parties hereto shall then jointly request the Court to stay all further proceedings in the above described action pending the disposition of proceedings at the FPC described herein subject to the reservation of rights in Section VIII.A. hereof, except that Lessees must answer the presently outstanding interrogatories.

[303]

V.

In addition, Lessor agrees fully to cooperate with and support such applications and pleadings as Lessees find it necessary or appropriate to file with the FPC to effectuate the agreement set forth herein. Lessees shall forward to Williams, Inc. and their attorneys copies of all correspondence, documents, pleadings, petitions, or exhibits, of whatever nature which they or either of them forward or file with the FPC, with respect to the application to the FPC to be filed pursuant hereto.

VI.

A. Williams, Inc. represents and warrants that it is authorized to execute this agreement on behalf of all parties listed on Annex A hereof and agrees to indemnify Lessees for any and all losses, damages, expenses and fees, including attorneys' fees, that may be sustained by Lessees as a result of lack of any such authority in Williams, Inc.

B. The undersigned signatories of each lessee represent and warrant that they have been fully authorized to execute this agreement on behalf of their respective corporations.

VII.

C. This agreement shall be binding upon and inure to the benefit of and be enforceable by the respective heirs, successors and assigns of the parties hereto.

VIII.

A. Lessees agree to use their best efforts to obtain the approval of the FPC to the procedures described in Section I. hereof. If the FPC refuses to authorize one of the procedures described in Section I. hereof,

[304]

or fails to issue other authorization acceptable to the parties hereto, on or before February 1, 1976, either Lessor or Lessees, acting together, may terminate this agreement by giving written notice of same to the other. In such event, neither this agreement nor any provision hereof shall constitute or be used as evidence in any pending or ensuing litigation between the parties hereto.

B. If any final order issued with respect to this agreement is reversed, remanded or modified by any court by an order which itself becomes final, then upon such event this agreement shall be terminated and gas delivered to Lessor

under this agreement shall be returned promptly to lessees and any monies paid under this agreement in excess of that which would have been paid or delivered in the absence of this agreement shall be returned within thirty days after such event. In such event, the 1934 lease and 1952 lease shall in no way be amended or modified by this agreement, and Section III hereof in such case shall not take effect.

IN WITNESS WHEREOF, this Agreement is executed as of the date and year first above written.

* * * *

[305]

ANNEX A

ROYALTY OWNERS IN THE GIBSON FIELD

Name and Address

Williams, Inc.
1323 Whitney Bank Building
New Orleans, Louisiana 70130

Succession of Laurence M. Williams
1323 Whitney Bank Building
New Orleans, Louisiana 70130

Mrs. Katharine W. Tremaine
1050 Coyote Road
Santa Barbara, California 93108

Through January 10, 1974:
The Kemper & Leila Williams
Foundation u/w Leila M. Williams
c/o First National Bank of Commerce
210 Baronne Street
New Orleans, Louisiana 70112

On January 11, 1974, The Kemper & Leila Williams Foundation u/w Leila M. Williams and The Kemper & Leila Williams Foundation u/w L. Kemper Williams were consolidated.

The Kemper & Leila Williams Foundation
c/o First National Bank of Commerce
210 Baronne Street
New Orleans, Louisiana 70112

F. B. Williams, as Executor of the Succession of Mrs. Delphine C. Williams
1323 Whitney Bank Building
New Orleans, Louisiana 70130

Frank B. Williams
1323 Whitney Bank Building
New Orleans, Louisiana 70130

Alec Andrew Johnson
11405 Arroyo Avenue
Santa Ana, California 92705

[306]

Lucille W. Mayfield Trust for Ann Marsak
c/o First National Bank of Commerce
210 Baronne Street
New Orleans, Louisiana 70112

Elizabeth Williams
Post Office Box 1007
Solvang, California 93463

Elizabeth Williams Trust
Elizabeth Williams,
Frank B. Williams,
Alec Andrew Johnson, Trustees
1323 Whitney Bank Building
New Orleans, Louisiana 70130

Ann Marsak
135 Miramar Avenue
Santa Barbara, California 93108

Lucille W. Mayfield Trust for Alec Andrew Johnson
c/o First National Bank of Commerce
210 Baronne Street
New Orleans, Louisiana 70112

Heirs of Cora Clark:

Mrs. Elizabeth Campbell Brooks
Prospect Street
Litchfield, Connecticut 06759

Whitney.L. Brooks, Trustee
P. O. Box 148
Torrington, Connecticut 06790

Allan Adams Campbell
Rising Corners
West Suffield, Connecticut 06093

Valley Bank & Trust Company
Executor u/w Holbrook Campbell
1500 Main Street
Springfield, Massachusetts 01115

[307]

APPENDIX B

June 23, 1975

United Gas Pipe Line Company
P. O. Box 1478
Houston, Texas 77001

Gentlemen:

Please refer to that certain gas purchase contract affective May 1, 1959, as heretofore amended ("Contract"), by and between United Gas Pipe Line Company, as Buyer, and Shell Oil Company, as Seller, under the terms of which Buyer is purchasing from Seller merchantable natural gas produced from certain lands and leaseholds located in Gibson Field, Terrebonne Parish, Louisiana. Seller has advised, as a result of litigation pending in *Shell Oil Company and Pennzoil Producing Company* v. *Williams, Inc., et al.,* Docket No. 573-591 (Civil District Court for the Parish of Orleans, State of Louisiana), that Seller may be required to make royalty payments to its lessors at a rate in excess of the rate heretofore paid as royalty or that in the absence of such greater royalty payments certain lessors have threatened to terminate some of the underlying leases. Seller has also advised that it is likely that other royalty owners in the Gibson Field will make similar demands. Seller has also advised that pursuant to a Settlement Agreement between Seller and certain of Seller's lessors, a copy of which is attached hereto as Exhibit A, payment of increased royalties or release of one-eighth of the gas back to such lessors may be required or permitted by the Federal Power Commission. In order to avoid the termination of leases and loss of gas to Seller and Buyer, Seller has requested that Buyer reimburse Seller for such excess payment for each of its lessors in the Gibson Field

or, in the alternative, release the royalty portion of the gas from the terms of the Contract. Buyer is agreeable to such arrangement on the following terms; accordingly, the parties hereto do hereby agree as follows:

1.

In the event Seller receives authorization from the Federal Power Commission to collect from Buyer increased sums payable to Seller's lessors as royalty on gas delivered after January 1, 1974, under the Contract, Buyer shall, beginning on the date Seller is authorized to collect such amounts, pay to

[308]

Seller such sums covering the periods authorized by the Federal Power Commission. Any payments authorized by the Federal Power Commission for royalty gas delivered after January 1, 1974, through the date of the Federal Power Commission's final order, shall be amortized over a period of one year from the date of the Federal Power Commission's final order. In the event of the cessation of Federal Power Commission regulation of producer gas sales as described in Exhibit A hereto, Buyer shall at all times pay to Seller the sums necessary to permit Seller to pay each of its lessors in the Gibson Field who have the right to receive a royalty on gas sold from such field by Seller to Buyer (regardless of whether such lessor is a party to the attached Exhibit A) the royalties specified in Exhibit A hereto; such payments shall be made from time to time as necessary to permit Seller to remit such sums to its lessors in a timely fashion and without regard to any other provision of the (May 1, 1959) Contract, except as amended hereby.

This Section 1 of this amendatory agreement shall automatically become void and of no force or effect on the date

the Settlement Agreement attached hereto as Exhibit A is terminated pursuant to the terms thereof.

2.

In the event Seller receives authorization from the Federal Power Commission to abandon or release to its lessors one-eighth (1/8) of such gas, Buyer will amend the Contract in such manner as to effect the release of such one-eighth (1/8) of such gas from the terms and provisions of the Contract; provided that Buyer will have no obligation under Sections 1 and 2 hereof unless and until either of the alternative authorizations is granted by final order of the Federal Power Commission as contemplated hereby.

3.

By its execution hereof Buyer does not become a party to, an obligor or guarantor under, beneficiary of or bound in any way by the Settlement Agreement attached hereto as Exhibit A.

4.

This agreement shall become effective as of the date first hereinabove written.

5.

This agreement is subject to all present and future orders, rules and regulations of any governmental or regulatory body having jurisdiction.

[309]

If the foregoing is in accordance with your understanding of the agreement between us, please so signify by executing the duplicate originals hereof in the space provided below and returning one of such originals to us. On our execution hereof, this agreement shall constitute an

amendment to the Contract and shall be binding upon us and upon our respective successors and assigns.

Very truly yours,

Shell Oil Company

By S. M. PAINE
S. M. Paine
General Manager
Production

ACCEPTED AND AGREED TO:

United Gas Pipe Line Company

By D. LAMAR SMITH

[314]

UNITED STATES OF AMERICA
FEDERAL POWER COMMISSION

Before Commissioners:

John N. Nassikas, Chairman;
William L. Springer, and Don S. Smith.

PENNZOIL PRODUCING COMPANY

Docket No. RI76-8

SHELL OIL COMPANY

Docket No. RI76-10

ORDER DENYING PETITIONS FOR SPECIAL RELIEF, SETTING DATE FOR HEARING ON APPLICATIONS FOR ABANDONMENT, AND CONSOLIDATING FILINGS

(Issued August 29, 1975)

On July 1, 1975 and July 18, 1975, Pennzoil Producing Company (Pennzoil) and Shell Oil Company (Shell), respectively, filed petitions in Docket Nos. RI76-8 and 76-10 for special relief from the just and reasonable rates under Opinion Nos. 598 and 699, as amended. The relief sought was for certain gas from the Gibson Field, Terrebonne Parish, Louisiana, under lease from Williams, Inc. *et al,* (Williams) and which is being sold to United Gas Pipe Line Company under FPC Gas Rate Schedule Nos. 234 (Pennzoil) and 202 (Shell). In the alternative, both petitioners requested authorization to abandon the royalty share of gas, effective January 1, 1974, but no later than October 1, 1975.

The gas is produced from acreage covered by leases with Williams dated August 29, 1934, and July 24, 1952. The 1934 lease provides that Pennzoil and Shell make royalty payments on the gas production thereunder equal to ⅛ of the market value prevailing at the well. The 1952 lease between Williams and Shell provides for royalty equal to ¼ of that value. In letters dated June 7, 1973, the March 27, 1974,

[315]

Williams demanded increased payments based on the market value clauses in the leases. His demands unmet, Williams declared both leases terminated on June 5, 1974. A lawsuit ensued out of which a settlement agreement dated June 18, 1975, was signed. That agreement provides that the instant petitions would be filed with the Commission seeking authorization for either of the following:

(A) Payment of royalty on each Mcf produced from the 1934 lease equal to ⅛, and from the 1952 lease equal to ¼ of the total of:

(1) the higher of

(A) the base royalty rate or

(B) the base alternative rate, plus

(2) 7¢ per Mcf or the full amount of the Louisiana severance tax, plus

(3) any Btu adjustments from 1000 Btu's

The "base royalty rate" is 78¢ per Mcf for 1975 and will increase 1.5¢ per Mcf annually beginning January 1, 1976. "Base alternative rate" is 150% of the highest area or national rate permitted or, in the case of deregulation, is the average of the three highest prices provided in sales for resale in the South Louisiana area; *or*

(B) Abandonment of that share of the gas sold under the leases attributable to Williams' royalty interests.

Should we take the course outlined in (A), Petitioners and United would amend their 1959 contract to provide for increased royalty payments by United which payments they request be made effective January 1, 1974, but no later than October 1, 1975. Petitioners' filing for the royalty increase will also contain a surcharge for royalty on volumes delivered between January 1, 1974, and the date of the Commission's final order.

[316]

In the event we authorized (B), United agreed to amend the 1959 contract to reflect the release of the royalty portion of the gas from the contract. A further proviso to the settlement agreement would permit cancellation of the agreement by either party should we not grant authorization prior to February 1, 1976. Due to the time limitation stated above, Petitioners also requested accelerated procedures, including the waiver of the intermediate decision, if a formal hearing were held.

The basic thrust of Petitioners' argument is that, pursuant to *Placid Oil Co. et al.* v. *F.P.C.*, 483 F.2d 880 (5th Cir. 1973), the Commission may grant special relief where higher than average royalties make a rate charged inappropriate. Petitioners state that United Gas Pipe Line Company, to whom they sell the gas, is in severe curtailment and is willing to pay the higher prices to keep the gas in its systems. Therefore, Petitioners argue, the public convenience and necessity warrants United's retaining this gas at the higher prices rather than risking termination of the leases in question and the possible diversion of the gas thereunder to the intrastate market.

The Commission finds:

(1) There is no justification for allowing a producer to pass through higher royalty costs to the consumer without a showing that Petitioners' overall costs are higher than those reflected in our Opinion No. 699-H.

(2) There is no basis for allowing a temporary surcharge for the purpose of permitting a producer to recover retroactive royalty payments.

(3) It is in the public interest that the petitions, insofar as they request abandonment of the gas subject to the royalty owner's interest, be set for hearing.

(4) Inasmuch as the petitions of Shell and Pennzoil involve identical issues and parties, the public interest will be served by disposing of these matters in the same hearing.

[317]

(5) The requested shortened hearing procedures with respect to accelerated dates is hereby granted. However, no good cause exists for granting the request for waiver and omission of the intermediate decision.

The Commission orders:

(A) Those portions of the petitions (A) filed by Pennzoil and Shell in Docket Nos. RI76-8 and RI76-10 relating to a request for rate increases due to increases in royalty payments are hereby denied.

(B) Those portions of the petitions relating to temporary surcharges for back royalty payments by Shell and Pennzoil are hereby denied.

(C) Pursuant to the Natural Gas Act, particularly Sections 4, 5, 7, 15, and 16 thereof, the Commission's Rules of Practice and Procedure, and the regulations under the Act (18 CFR, Chapter I), those portions of the Shell-Pennzoil petitions relating to the abandonment of the gas associated with royalty owners' interests are set for the purpose of hearing and disposition.

(D) The portion of the petitions to abandon sales of royalty volumes filed by Pennzoil and Shell in Docket Nos. RI76-8 and RI76-10, respectively, are hereby consolidated for the purpose of hearing and disposition.

(E) A public hearing on the issues presented by the portion of the petitions to abandon sales of royalty volumes shall be held commencing September 23, 1975, at 10:00 A.M. (EDT) in a hearing room of the Federal Power Commission, 825 North Capitol Street, N.E., Washington, D.C. 20426.

(F) A Presiding Administrative Law Judge to be designated by the Chief Administrative Law Judge for that purpose (See Delegation of Authority, 18 CFR 3.5(d)), shall preside at the hearing in this proceeding pursuant to the Commission's Rules of Practice and Procedure. The Presiding Administrative Law Judge shall issue his initial decision on or before November 26, 1975.

[318]

(G) Applicants and any intervenor supporting the application shall file their direct testimony and evidence on or before September 9, 1975. All testimony and evidence shall be served on the Presiding Administrative Law Judge, the Commission Staff, and all other parties to the proceeding.

(H) The Commission Staff and all intervenors opposing the application shall file their direct testimony and evidence on a date to be fixed by further order of the Presiding Administrative Law Judge. All such testimony and evidence shall be served upon the Presiding Administrative Law Judge and all other parties.

(I) Any party or Staff Counsel desiring to oppose any filed exceptions shall file such objections on or before December 19, 1975.

By the Commission.

(SEAL)

KENNETH F. PLUMB,
Secretary.

[331]

UNITED STATES OF AMERICA
FEDERAL POWER COMMISSION

Before Commissioners:
John N. Nassikas, Chairman;
William L. Springer, Don S. Smith,
and John H. Holloman III.

PENNZOIL PRODUCING COMPANY

Docket No. RI76-8

SHELL OIL COMPANY

Docket No. RI76-10

ORDER GRANTING APPLICATION FOR REHEARING, VACATING PORTION OF ORDER DENYING PETITION FOR SPECIAL RELIEF, AND GRANTING INTERVENTION

(Issued September 22, 1975)

On September 9, 1975, Pennzoil Producing Company (Pennzoil) filed herein an application for rehearing of the Commission's order issued in the above docket on August 29, 1975. The August 29 order rejected petitions for special relief by Pennzoil and Shell Oil Company from the just and reasonable rates for gas under lease in the Gibson Field, Terrebonne Parish, Louisiana. The petitions were filed as a result of demands by Williams, Inc. *et al.*, the lessor, for increased royalty payments based upon contractual market value royalty clauses. We rejected the petitions, finding no justification for allowing producers to pass through higher royalty costs without a showing that overall costs were higher than those set forth in Opinion No. 699-H.

In its application for rehearing, Pennzoil argues that, by excluding the rate increase request from being heard, the Commission is excluding consideration of the problems associated with "market value" royalty claims based on prices above those we have approved. Applicant also points out that this issue has been raised and set for hearing in *Roy M. Huffington*, Docket No. CI75-602. Pennzoil contends that foreclosing their right to present evidence which would justify the rate increase constitutes an "undue and unlawful discrimination against Pennzoil." We recognize the fact that identical issues have been raised in both proceedings. Therefore, we shall grant Pennzoil's request for rehearing. Upon our own motion we shall also apply this ruling to Shell Oil Company. Pennzoil has already submitted evidence relating to its petition for special relief. We shall give Shell the opportunity to do likewise, if it so desires.

[332]

Good cause exists to permit the intervention of the following petitioners: Chevron Oil Company, Western Division; California Oil Company, a Division of Chevron Oil Company; United Gas Pipe Line Company; Southern Natural Gas; Associated Gas Distributors; Michigan Wisconsin Pipe Line Company; and Mississippi River Transmission Company.

The Commission orders:

(A) Pennzoil's application for rehearing filed herein September 9, 1975, is granted.

(B) That portion of the August 29, 1975 order denying Pennzoil's and Shell's petitions for special relief is hereby vacated.

(C) Shell Oil Company shall file any additional testimony and evidence relating to its request for authorization

to collect increased rates on a date to be fixed by further order of the Presiding Administrative Law Judge. Such testimony and evidence shall be served upon the Presiding Administrative Law Judge and all other parties.

(D) The above-named petitioners are permitted to intervene in this proceeding subject to the rules and regulations of this Commission; *Provided, however,* that the participation of such intervenors shall be limited to matters affecting asserted rights and interests as set forth in said petitions for leave to intervene; and *Provided, further,* that admission of such interests shall not be construed as recognition by the Commission that it might be aggrieved because of any order or orders entered in this proceeding.

By the Commission.

(SEAL)

KENNETH F. PLUMB,
Secretary.

[1]

BEFORE THE
FEDERAL POWER COMMISSION

Inthe Matter of:
PENNZOIL PRODUCING COMPANY
AND
SHELL OIL COMPANY

Docket Nos: RI-76-8 RI-76-10

Hearing Room "G"
825 North Capitol Street
Washington, D.C.
Tuesday, September 23, 1975

The hearing in the above-entitled matter met, pursuant to Notice, at 10:00 a.m..

BEFORE:

SAMUEL Z. GORDON, Presiding Administrative Law Judge

* * * *

[23]

PENNZOIL PRODUCING COMPANY

Direct Testimony of
A. DUNCAN GRAY, JR.

Q. Would you please state your name and business address?

A. My name is A. Duncan Gray, Jr. My business address is 900 Southwest Tower, Houston, Texas 77002.

Q. How are you employed?

A. I am General Attorney for Pennzoil Company (Pennzoil) — Oil and Gas Operations. I am also Vice President and General Attorney of Pennzoil Producing Company (Producing).

Q. Please outline your educational background and experience.

A. I graduated with an A.B. from Dartmouth College in 1960. I received a J.D. from the University of Michigan in 1963 and an L.L.M. (Taxation) from New York University in 1964. I practiced with Baker & Botts from 1964 through November of 1972 at which time I became the General Attorney for Pennzoil's Oil and Gas Operations as well as General Attorney of Producing. In August, 1974, I became a Vice President of Producing.

Q. What is the purpose of your testimony?

A. By its petition in this docket, Producing has requested the Commission to take action which will allow implementation of a settlement agreement reached in a lawsuit arising out of claims made by Williams, Inc. (Williams) as lessor-royalty owner against Producing and Shell Oil Co. (Shell) as lessees. I was intimately involved in the negotiations which led to that settlement. The purpose of my testimony is to describe the circumstances surrounding the lawsuit, the negotiations and elements of the settlement, and the evidentiary support for granting Producing's petition so as to allow implementation of the settlement.

Q. Would you please describe the factual background out of which the litigation between Producing and Williams arose?

[24]

A. Producing and Shell produce and sell in interstate commerce gas from acreage in the Gibson Field, Terrebonne Parish, Louisiana, which is covered by a 1934 lease from Williams (then F. B. Williams Cypress Company,

Limited) to Shell (then Shell Petroleum Corporation). A portion of the acreage was subleased by Shell to Producing (then Union Producing Company) on December 29, 1942.

Q. To whom does Producing sell the gas it produces from the acreage covered by the 1934 lease?

A. Producing presently sells that gas in interstate commerce to United Gas Pipe Line Company (United) under Producing's Rate Schedule No. 234.

Q. What price does Producing receive for the gas?

A. Some is covered by Opinion No. 598 for which we receive 31.11¢ per Mcf, including all adjustments, and some is covered by the national rate at 59.88¢ per Mcf, including all adjustments.

Q. How did the lawsuit arise?

A. By letters dated June 7, 1973, and March 27, 1974, Williams demanded payment of royalty based upon so-called market values substantially in excess of the price the Commission permits us to receive from United. In addition, by letter dated June 5, 1974, Williams declared the lease terminated because of our alleged failure to pay the royalty which Williams claimed. In an attempt to prevent lease termination and imposition of such increased royalties, we filed suit against Williams in the Civil District Court in Orleans Parish, Louisiana, asking for a declaratory judgment that we are paying the correct royalty. By Reconventional Demand (counterclaim), Williams requested the Court to order (1) termination of the lease effective June 5, 1974, (2) an accounting for and payment of the value of all minerals produced under the lease since June 5, 1974, (3) payment of $1,055,204.62 in "underpaid" royalties for the period through May 31, 1974, and (4)

payment of damages and attorneys' fees. The "underpayment" of royalties was calculated on the basis of an increasing market value of gas up to 70¢ per Mcf for the period from November, 1973, through May, 1974. Williams has since amended its Reconventional Demand to cover the period from June 1, 1974, through April 30, 1975, alleging additional underpayments of royalties by Producing of $1,989,222.91 based on an alleged market value of $1.30 per Mcf from June 1, 1974, through December 31, 1974, and $1.40 per Mcf from January 1, 1975, through April 30, 1975. Basically, these mineral owners want the lease terminated for what they

[25]

perceive to be an intentional breach of the obligation of the mineral lessee to pay royalties due. The Reconventional Demand claimed default in Producing's obligation and termination of the lease and asks the Louisiana court to recognize and decree a termination, and order Producing and Shell off the lease, returning full possession of the minerals and rights of production to the mineral owners.

Q. Are you sponsoring any exhibits?

A. Yes. My exhibits are copies of, first, the June 7, 1973, letter, second, the March 27, 1974, letter, third, the June 5, 1974, letter, fourth, our complaint in the lawsuit, fifth, Williams' Reconventional Demand and, sixth, Williams' recent amendment to its Reconventional Demand.

Q. Please briefly describe the basic provisions of the settlement agreement.

A. The description in Section IV of our application succinctly and accurately describes the settlement agreement and I hereby adopt that description as my answer.

Q. Is there a possibility of substantial damages, increased royalties or lease termination if the lawsuit continues?

A. I am not a Louisiana lawyer and I will not purport to testify as to what the Louisiana court will hold. However, Williams, Inc. is vigorously prosecuting its claims and we are forced to consider this a serious lawsuit.

Q. Why did Producing enter into the settlement agreement?

A. We entered into the settlement agreement because we believe that either payment of increased royalties by the consumers of gas or the abandonment of the royalty share of the gas is preferable to the risk of either losing all the gas or the imposition by a court of damages and royalties which might be substantially higher than those contemplated by the settlement agreement.

Q. Is there a risk that the court could impose royalties in excess of those set out in the settlement agreement?

A. The settlement agreement would base royalty on the higher of (a) 78¢ for 1975 plus 1.5¢ per year or (b) 150% of the national rate or, in the event of deregulation, the average of the three highest prices in producer sale for resale contracts in the South Louisiana area. Williams'

[26]

demand is for royalty based on $1.40 per Mcf from January 1 through April 30, 1975. We do not know what market value they will allege for the period after April 30, 1975, but I think we can expect allegations of market value in excess of $1.40 per Mcf.

Q. Addressing solely the abandonment issue; why would it be in the public interest to permit Producing to abandon the royalty gas?

A. The risk is the possibility of lease termination or even higher royalties. United and its customers would be better served by giving up one-eighth of this gas than running the risk of losing it all, or of having a court impose much higher royalties and damages which might possibly then be passed on to the consumer in whole or in part.

Q. Why would it not be best for Producing itself to simply absorb any such damages and royalties?

A. That would not benefit anyone except the royalty owner and would in fact be detrimental to the public interest. The royalty owner would get more money but we would have that much less funds available for exploration and development of this lease as well as other leases. It seems that when gas is in short supply all efforts should be made to ensure that such a result would not occur.

Q. Why would it not be best just to let the lawsuit proceed?

A. For all the reasons I have given above as to why the settlement is in the public interest, plus the fact that if the lease were terminated and the gas lost to United and its customers, this result arguably could be a precedent for the other so-called market value leases in Louisiana. The ultimate loss of gas to the interstate market could be very substantial. As you know, there is a substantial question whether, if the lease is terminated, the gas could under the Natural Gas Act be diverted from the interstate market. While the Commission has ruled on that in *El Paso* (Opinion No. 737), that case is subject to appeal and may well be reversed. Even if the lease is terminated and if it is ultimately determined that Williams must continue to sell the gas to United, Williams may be able to collect the national rate, or even 130% of the national rate under the Commission's recent small producer order, for all of the gas instead

of the roughly one-third which currently qualifies for the national rate; if that happened, United and its customers might well end up paying more for this gas than they would if the royalty flow-through is allowed. The

[27]

ultimate answer to that question is unknowable at this time, but the settlement would avoid that risk.

Q. Addressing the royalty flow-through question, what would be the rate effect of permitting payment and flow-through to United of the increased royalty under the settlement?

A. As an example, if Producing is permitted to collect the increased royalty on July 1, 1975, the increased royalty for volumes delivered through each month remaining in 1975 will average 8.0017¢ per Mcf, including Btu adjustment. The surcharge, if placed into effect July 1, 1975, will be 8.6457¢ per Mcf, including Btu adjustment; 5.4205¢ of that total will be attributable to volumes delivered between January 1, 1975 and July 1, 1975, and the remaining 3.2252¢ per Mcf will be attributable to volumes delivered during 1974.

Q. Why would it be in the public interest to permit Producing to pay the increased royalty set out in the agreement and flow it through to United?

A. It would be in the public interest for all the reasons which I described above, plus it would assure that United and its customers would get all this gas instead of perhaps only seven-eighths or even none.

Q. Which of the two alternatives set out in the settlement agreement — increased royalty payments or abandonment — would be preferable?

A. So far as United and its customers are concerned, my opinion would be that they would be better off being assured of all the gas at a slightly higher price than receiving only seven-eighths of it or perhaps none. It is interesting to note that, to the best of my knowledge, none of United's customers who would have to pay the increased royalty are opposing our application. I think it is also significant that if the settlement is approved Producing will not receive any additional revenue.

* * * *

[30]

MR. STEVENS: Your Honor, I have a couple of questions for Mr. Gray, as supplementary direct, before I tender him for cross examination.

PRESIDING JUDGE: Very well.

BY MR. STEVENS:

Q. Mr. Gray, regarding the Williams 1934 lease, which is one of the subjects of this proceeding, does Producing have any development plans for that property for the next year or so?

A. Our operating people in our Lafayette, Louisiana office tell me that we have, during 1976, one development well and one work-over of an existing well planned.

The development well will be drilled to a shallow, 2,200-foot sand, and the work-over would be recompletion of an existing well in a shallower sand.

Q. What are the estimated reserves for each of those projects?

A. The estimated reserves? The reserves, as estimated by our operating people, are: The development well, which is the Pelican A-10, that well would produce 1.65 Bcf of gas; and the work-over, which is called the Koontz No. 13, would

produce from the sand, when it's recompleted, 2.42 Bcf of gas.

Q. Are those plans currently in Producing's budget?

A. Either they are in Producing's budget or they

[31]

will be in Producing's budget as submitted by the Lafayette office for 1976.

Q. Will Producing do that work in 1976 if Producing is forced as a result of litigation in Louisiana to pay royalty based on $1.40 or above?

A. Again, our operating people tell me that the payment of royalty at $1.40 or above combined with a presently-available price for this gas of 52 cents would cause them to defer indefinitely these plans.

PRESIDING JUDGE: Excuse me. The royalty based on $1.40, or what would the royalty come to, actually?

MR. STEVENS: Judge, based on $1.40, it's one-eighth; it would be 17½ cents.

PRESIDING JUDGE: I see.

BY MR. STEVENS:

Q. Mr. Gray, you mentioned a price of 52 cents. I believe that's for new gas under the national rate.

Do you have an idea about what is Producing's average price to United for gas on the Williams lease, without btu adjustment or tax reimbursement?

A. It's approximately 36 cents.

Q. Do you have an estimate as to what that price would rise to if the Commission permits the royalty flow-through that we are requesting here?

A. The price would rise to approximately 44 cents

[32]

per mcf.

Q. Do you have an estimate of what that price would rise to if the Commission allows both the royalty flow-through that we're requesting here plus the surcharge that we're requesting?

A. The price would be 52 cents for the next 12 months and then it would drop back to 44 cents.

Q. Do you have an estimate of what the price would be if the lease reverted to Williams and Williams continued to sell the gas to United, but was entitled to collect the small producer price?

A. The price would be approximately 68 cents, which is 52 cents which is the national rate for new gas, plus 16 cents which is 30 percent of 52 cents.

These prices, incidentally — all of the prices I've mentioned — are without the components for tax reimbursement or btu adjustment.

MR. STEVENS: Your Honor, we submit Mr. Gray for cross examination.

PRESIDING JUDGE: I don't know if you'd call it cross since your interests are exactly the same, but does Shell wish to examine?

MR. JOHNSON: No, Your Honor.

PRESIDING JUDGE: Does United?

MR. ARNETT: No, Your Honor.

* * * *

[46]

UNITED GAS PIPE LINE COMPANY

Prepared Testimony of
D. LAMAR SMITH

Q. Please state your name and business address.

A. D. Lamar Smith, 700 Milam, Houston, Texas.

Q. What is your position at United Gas Pipe Line Company?

A. Senior Vice President — Gas Supply.

Q. What is your educational background?

A. I graduated from Texas A & M University in 1958 with a B.S. Degree in Mechanical Engineering and from Southern Methodist University in 1961 with an LLB Degree. I am a member of the bar of the state of Texas.

Q. Please describe briefly your business and professional experience.

A. Upon graduation from law school in 1961, I was employed by Tennessee Gas Pipeline in its Planning Department. In December 1963, I joined Mobil Oil Corporation as a Natural Gas Attorney in New York City. In 1967 I was transferred from Mobil's Legal Department to its Natural Gas Unit where I participated in the negotiation of Mobil's major natural gas sales in the North American Exploration and Production Division. I left Mobil in December 1968, and from that time until December 1970, I practiced law as a partner in the law firm of Kerr & Smith in Ft. Stockton, Texas, and as General Counsel of Texas Crude Oil Company. In December 1970, I joined United Gas Pipe Line Company as an attorney. In November 1973, I was made Vice President — Gas Acquisition, and in June 1974, I was made Senior Vice President —Gas Supply.

Q. What corporate functions are under your direction and supervision?

[47]

A. I am in charge of five corporate functions: (1) Gas Acquisition, (2) Reserves, (3) Proration and Deliverability, (4) Gas Purchase Contract Administration and (5) Gas Management.

Q. What is the purpose of your testimony in this proceeding?

A. I am presenting evidence on behalf of United concerning its agreements with Pennzoil Producing Company (Pennzoil) and Shell Oil Company (Shell) whereby United agreed, upon Commission approval, to pay higher rates to cover the claim of Williams, Inc. (Williams), lessor-royalty owner, for higher royalties or alternatively, to release the royalty portion of the gas from the gas purchase contracts.

Q. Are you submitting any exhibits in support of your testimony?

A. Yes.

Q. Will you please describe each of your exhibits?

A. Exhibit No. 7 (DLS-1) is the letter agreement between United and Pennzoil.

Exhibit No. 8 (DLS-2) is the letter agreement between United and Shell.

Q. What were the circumstances surrounding the execution of these agreements with Pennzoil and Shell?

A. Prior to my execution of these agreements on behalf of United, I was advised by Pennzoil and Shell that as a result of pending litigation in *Shell Oil Company and Pennzoil Producing Comapny* v. *Williams, Inc., et al.*, Docket No. 573-591 (Civil District Court for the Parish of Orleans,

State of Louisiana), that they may be required to make royalty payments to their lessors at a rate in excess of the rate heretofore paid as royalty or that in the absence of such greater royalty payments, certain lessors have threatened to terminate their leases. In fact, Williams had declared the leases terminated as of June 5, 1974, and this issue is presently before the court in the above-mentioned litigation. Further, I was also advised, that in an attempt to resolve the issues presented by this litigation, Pennzoil and Shell entered into a settlement

[48]

agreement with Williams whereby they would, among other things, seek Commission approval of higher rates to United or abandonment of the royalty portion of the gas. United considers the issues presented by the so-called market value royalty litigation to be serious ones. If Williams is successful in obtaining lease termination, United and its customers may very well lose all the gas United is currently purchasing from the acreage covered by these leases. I therefore agreed to execute the letter agreements, pending Commission approval, to give effect to the settlement reached between the parties since it appeared to be in the best interest of United and its customers to do so. It is preferable from our standpoint, and we think from the standpoint of United's customers, to resolve this controversy as proposed by Pennzoil and Shell than to risk the loss of all the gas involved.

Q. Why do you believe that these agreements are in the best interest of United and its customers?

A. Concerned that the litigation between Pennzoil, Shell and Williams could result in the termination of the leases and loss of the gas, United agreed to pay higher rates based upon the increased royalty demand to keep the

entire package of gas in its system. If this first request were not allowed by the Commission, United then agreed that it would release the royalty portion of the gas in order to avoid the risk of losing the remaining portion of the gas. Of course, United preferred the first alternative over the second.

Q. What is the amount of gas involved.

A. In 1974, United purchased 25,588,412 Mcf from Pennzoil and 12,573,991 Mcf from Shell. On a daily basis this represents the purchase of approximately 70,105 Mcf from Pennzoil and 34,449 Mcf from Shell. The estimated remaining recoverable reserves as of January 1, 1975 in the Gibson Field attributable to Shell and Pennzoil were 68.7 Bcf and 86.2 Bcf, respectively.

Q. What is United's current gas supply situation?

A. As everyone is aware, United has a serious gas supply shortage and has been curtailing its customers on a continuous basis since November 1970. Projected curtailments for the year ending March 1976 are expected to exceed last year's curtailments. During this period of

[49]

curtailment, United has continued to pursue a vigorous gas acquisition effort to add new gas to its system and to maintain that gas already in its system for the benefit of its customers.

Q. What is the possible effect of this proceeding on United's gas supply?

A. If the Commission approves the requests of Pennzoil and Shell to abandon the royalty portion of the gas, United will retain the major portion of the gas available to it from these leases. If the Commission had approved the increased rates, United would have of course been assured of the

continuing supply of all the gas at a higher price. Either alternative is preferable, however, to the possible loss of the entire amount of gas to United, its customers and interstate commerce.

Q. In your opinion does the public convenience and necessity require the Commission to approve abandonment of the royalty share of the gas under the circumstances as you understand them?

A. United would, of course, prefer to retain all of the gas available to it from these leases. In view of the uncertainty surrounding the outcome of the market value litigation in the state of Louisiana, the only way to ensure the retention of all the gas is to grant the request of Shell and Pennzoil for rate increases to cover Williams' demand for increased royalty payments. Unless the Commission reconsiders its action of August 29, 1975, foreclosing that relief, the public interest will be best served by the abandonment of the royalty gas and the retention of the larger portion of the gas, that which is attributable to the working interests. Otherwise, United and its customers are faced with the possible loss of all of the gas attributable to the leases in the event of an adverse decision by the Louisiana Courts. This would, of course, increase United's rate of curtailment which is already extremely high. During this period of acute gas shortages, United would certainly prefer to retain as much gas as possible. However, in this particular instance, United is faced with the possible loss of all the gas and therefore it has no alternative to the abandonment of the royalty portion of the gas.

Q. Does this conclude your testimony?

A. Yes.

* * * *

[61]

but I thought you gave two prices, one at 30.50 and one at 30.59. Is that wrong?

THE WITNESS: That's correct.

MR. JOHNSON: I didn't hear any figure then for the 30.50 in terms of volumes.

THE WITNESS: That was the 8.317 Bcf. The next number for the 30.59 should be 84,000 Mcf.

MR. JOHNSON: 84,000?

THE WITNESS: I thought I had given you it. That's when you asked your question. Excuse me.

BY MR. ARNETT:

Q. Mr. Smith, yesterday the Commission issued its Order granting application for rehearing vacating portion of Order denying petition for special relief and granting intervention.

Do you have further testimony in light of this Order issued by the Commission?

A. Yes I do. In light of the settlement agreement, which established a negotiated settlement price of 78 cents per Mcf for royalty gas with add-on subject to other adjustments based on Commission action, which I feel is very reasonable in light of today's market price, and in light of the tremendous potential loss that United would face in the event that this case went to court and the leases were lost.

[62]

Approximately 65 percent of all United's gas supply comes from leases within the State of Louisiana. We're curtailing today at 2.5-billion cubic feet per day. Now, we cannot stand to lose one foot of gas. We thought this settlement was in the public interest and the interest of our cus-

tomers and in the interest of the producers and the land owners.

Now, we are prepared to show from the same document I was quoting from, United's latest effective purchase gas adjustment filing, what the latest arm's-length intrastate prices are in this area of South Louisiana, and it will show when I read these numbers the very reasonable price level of 78 cents for the settlement.

The reason these numbers are in our PGA is there is a certain number of sales by producers to United which are now considered by the producer and United and the Federal Power Commission, at least today, to be non-jurisdictional as to the sales of the producer to United. These contracts in the main contain price redetermination provisions based upon the average of the three highest prices in the area, interstate or intra, whatever the highest price.

Therefore, these redeterminations have been triggered and are shown in our PGA and they are, in fact, paying those prices today to these producers.

But the point of this filing is to show what the

[63]

new going price as of July would be in South Louisiana for freely-negotiable gas between a willing buyer and a willing seller in the intrastate market, and I think it would be significant to the Judge and to the Commission to show how much cheaper the settlement price is for gas which, if released, we would be in there trying to buy in this non-jurisdictional phase, at prices well above $1.50.

So, with that I will identify for you particular contracts of United's to producers in excess of area rate, which are approved, as of today, at least, to be non-jurisdictional between the seller of the gas and United. And I will try

to identify for you the page of our PGA so Staff and the other parties could so verify these other numbers.

PRESIDING JUDGE: When you say they are "non-jurisdictional" do you mean — well, are they 60-day emergency purchases?

THE WITNESS: No, sir, these are long-term contracts, Your Honor. The gas is sold to United into a certificated system but the gas physically cannot leave the State of Louisiana, and under various cases, including the case of United, the gas does not go out of the state and is not commingled with gas that goes out of the state, and therefore under today's state of the law and in our rate cases the producers do not file for certificates to make

[64]

such sales at this time.

PRESIDING JUDGE: I see.

THE WITNESS: All right. Exhibit A, Schedule Number 2, page 13 of 104, on line 27 we have a contract with Texaco, Inc. in the Grand Bay Field, South Louisiana, and the effective price is $1.47+, plus meaning some tenths or hundredths of cents.

Page 17 of the same Exhibit A, line 29, producer names Charles T. McCord, Lake Long Field, South Louisiana, and the price is 116.37 cents.

Page 19 of the same schedule, La Pice Field, line 23, Shell Oil Company, $1.12.

La Pice Field, Shell Oil, 108.04 cents.

La Rose Field, Pennzoil Producing, 157.86 cents.

Page 23 of that schedule, Valentine Field, General American Oil Company of Texas, 116.20 cents.

Page 29, Deep Lake Field, Pennzoil Producing, 157.86 cents.

Page 33, line 15, Forest Oil Company, Grand Cheniere, 110.78 cents.

Page 37, line 28, Manchester Field South, Willard E. Walker Producer, 136.30 cents.

Now, those are the list of contracts, based upon price redeterminations in the area that are all in excess of $1.00. I have not attempted to find any between 78 cents

[65]

or the area rate and a dollar, but I think they are significant, that that is the average going price in these areas and I believe the settlement price is more than reasonable in light of the going price.

I might say further United, and I believe there is evidence by the appearance of Michigan, Wisconsin, all pipelines are heavily concerned about market value royalty cases. There are a number of such cases in the courts in the State of Texas, and the law is undergoing some revisions so possibly when it gets to the Supreme Court of the State of Texas — but there are significant claims that have been in interstate commerce for many years, and they may be serious blows to the producers as well as to the pipelines if the outcomes of those are against the pipeline purchasers or the producers.

But under payment of royalty, in Louisiana with the law being different, the possibility of losing the lease is very high and that is a very horrendous possibility to us, and in our opinion it is unwise for either the Staff or the Commission to ignore the realities of the state of the law in these various states.

We're aware of a royalty problem in West Texas. I am a Texas lawyer. I am not a Louisiana lawyer. My personal

opinion is that the Commission is going to lose that case in the Southland litigation under the laws of the State

[66]

of Texas.

I would hope that the Commission and the Staff would support and would look with reason at reasonable settlements of litigation between producers and their royalty owners.

Now, there is a tremendous price disparity, as everyone is aware, between the new intrastate prices and the regulated price today of 52 plus adjustments, and I believe the old, traditional position of being against anything new and innovative to be reasonable in the marketplace, to help the pipelines and the consumers, and the pipelines keep all the gas possible is going to take some rude awakening on the part of all of us, and it's small consolation to United or United's customers to take the position "no, you can't do anything and make it go."

All these cases in litigation in state courts where the outcome is uncertain, the litigation could drag on for years and years, and the Commission may lose. And I would not be surprised to see land owners win a case in the State Courts, take over operation of the wells despite FPC mandate, and at least while litigation is pending there is a chance the landowner could win the lawsuit, could take the gas, despite what the Commission may say, that 7-B is necessary.

The Supreme Court has yet to opine on that, and it might rule in favor of the royalty owner or the land owner.

[67]

So, it's again a small consolidation to win a moral victory in a case like this and put the burden on the producer. The producer might lose the lease.

So, with those remarks, I am prepared to answer further questions on the price issue, Your Honor, or on the prepared testimony.

MR. ARNETT: I tender the Witness for cross examination, Your Honor.

PRESIDING JUDGE: Very well.

Mr. Stevens, do you have any questions?

MR. STEVENS: No, sir.

PRESIDING JUDGE: Mr. Johnson?

MR. JOHNSON: No, Your Honor.

PRESIDING JUDGE: Ms. Province?

MS. PROVINCE: Yes. I have only one question for Mr. Smith.

PRESIDING JUDGE: Very well.

CROSS EXAMINATION

MY MS. PROVINCE:

Q. Mr. Smith, you earlier provided us with a breakdown as to the volumes and rates received.

Do you also have information of what portions of the royalties and gas are subject to the one-eighth royalty payment and which are subject to the one-fourth?

A. We keep records only in total volumes purchased.

* * * *

[73]

FPC Docket No. RI76-10

Prepared Testimony of JOHN F. BRUSKOTTER On Behalf of Shell Oil Company

Q. Please state your name, occupation and educational background.

A. My name is John F. Bruskotter. I am Manager, Natural Gas Marketing, Southern Region, Shell Oil Company. I was graduated from Missouri School of Mines in 1952 with a B.S. degree in Petroleum Engineering.

Q. Please describe your professional experience.

A. I have been employed by Shell Oil Company since graduation. In 1959, I was named Division Reservoir Engineer for Shell's Oklahoma City Division and in 1964, I was assigned to Shell's Exploration and Production Research Center, Houston, Texas as Senior Reservoir Engineer. About one year of this assignment was devoted to research on gas well performance. The results of my work and that of others within my research group was published in the Journal of Petroleum Technology in 1965. In 1966, I was named Staff Reservoir Engineer and was assigned to the New Orleans area. Until 1968, I was responsible for all reservoir engineering in the onshore areas of Louisiana and Mississippi. From mid-1968 until mid-1971, I was Division Petroleum Engineer for the onshore West Division. In June of 1971, I was appointed to my present position as Manager, Natural Gas Marketing, for Shell's Southern Region. The principal producing areas within this Region are the Gulf of Mexico, the east half of the State of Texas, and the States of Louisiana, Mississippi, Alabama and Florida.

Q. To what professional organizations do you belong?

A. I have been active in various professional societies and have served on various industry committees. As a member of the Society of Petroleum Engineers of AIME, I have served on the Continuing Education Committee in New Orleans and was Vice Chairman for Reservoir Engineering on the General Editorial Committee of the Society of Professional Engineers. The industry committees on which I have served include the Oil Scouts Association, Engineering Subcomittee for the Mid-Continent Oil & Gas Association, and the API and AGA Reserve Committees. I am a member of the Society of Petroleum Engineers of AIME, the API and the Gas Men's Association. I am a registered professional engineer in the State of Oklahoma.

[74]

Q. What is the purpose of your testimony in this proceeding.

A. By Order issued August 29, 1975 the Commission ordered a public hearing on Shell's Petition to abandon that portion of its certificate in Docket No. G-5037 and Shell's Rate Schedule No. 202 which is attributable to the mineral or royalty interest listed on Annex A of the Settlement Agreement attached to Shell's Petition in these proceedings, now collectively referred to as "Williams, Inc." The purpose of my testimony in this proceeding is to state Shell's reasons why this Petition should be granted.

Q. Would you state briefly the background of the controversy between Shell and the royalty owners referred to as Williams Inc.

A. Shell sells gas produced from the Gibson Field, Terrebonne Parish, Louisiana, to United under Shell's FPC Rate Schedule No. 202. This sale was originally cer-

tificated in Docket No. G-5037 on May 28, 1956 at which time Shell's gas sales contract was designated as FPC Gas Rate Schedule No. 50. Upon the execution and filing of a replacement contract, dated May 1, 1959, the rate schedule designation was changed to No. 202, as noted in the Commission's Order dated June 11, 1959 in Docket No. G-18697 and the Commission's letter dated July 6, 1959.

A portion of the gas sold to United is produced from acreage covered by Mineral Lease dated August 29, 1934 (the 1934 lease) from F. B. Williams Cypress Company, Limited (now Williams, Inc.), to Shell Petroleum Corporation (now Shell) and by Mineral Lease dated July 24, 1952 (the 1952 lease) from Williams, Inc. to certain parties (which lease was assigned to Shell on January 24, 1955). A portion of the acreage covered by the 1934 lease was subleased to Union Producing Company (now Pennzoil Producing Company) on December 29, 1942. Certain portions of the 1934 lease have been unitized and are hereinafter referred to as "Unitized Acreage".

The 1934 lease provides for royalty of the gas production thereunder equal to one-eighth "of the value thereof,

[75]

calculated at the market rate prevailing at the well", and the 1952 lease provides for royalty on the gas production thereunder equal to one-fourth "of the value thereof, calculated at the market price prevailing at the well".

On June 7, 1973, and again on March 27, 1974, Williams, Inc. demanded payment by Shell for gas produced from acreage covered by these leases based on the so-called "market value" clauses contained therein. Further, on June 5, 1974, Williams, Inc. declared both the 1934 lease and the 1952 lease terminated because of Shell's alleged failure to pay the royalty claim by Williams, Inc.

In order to protect its legal rights and interests in these leases, Shell and Pennzoil Producing (against whom similar demands were made by Williams, Inc.) filed a petition on May 24, 1974 in the Civil District Court in the Parish of Orleans, Louisiana (*Shell Oil Company and Pennzoil Producing Company* v. *Williams, Inc., et al.*, Docket No. 578-591) asking issuance of a judgment declaring that Shell and Pennzoil Producing are paying the appropriate royalty. By reconventional demand, Williams, Inc., requested the Court to order cancellation of both the 1934 lease and the 1952 lease effective June 5, 1974 and an accounting for, and payment based on the value of, all minerals produced under such leases since June 5, 1974.

Shell and Williams, Inc. have entered into a Settlement Agreement dated June 18, 1975 (attached to Shell's Petition as Appendix A) which will permit Shell to retain both the 1934 lease and the 1952 lease and continue to sell natural gas to United for the interstate market upon the payment of higher royalties to Williams, Inc. The Settlement Agreement provides that Shell will make such applications to the Federal Power Commission as may be necessary to obtain authorization for the following:

(A) Payment by Shell of royalty on each Mcf produced and sold from Unitized Acreage and under the 1952 lease, equal to one-eighth in the case of the Unitized Acreage and one-fourth in the case of the 1952 lease, of the total of:

(1) the higher of

(a) the base royalty rate, or

(b) the base alternative rate, plus

[76]

(2) 7¢ or the full amount of the Louisiana severance tax, which amount is to be increased as the severance tax of the State of Louisiana is increased, plus

(3) the full amount of federal taxes imposed upon Williams, Inc., plus

(4) any upward or downward adjustment for Btu content of the gas containing more or less than 1,000 Btu per cubic foot, and

pass through to United of the portion of such total which exceeds current royalty payments by Shell to Williams, Inc.

In connection with the above, "base royalty rate" is 78¢/Mcf as of January 1, 1975, increasing 1.5¢/Mcf each January 1st beginning January 1, 1976. "Base alternative rate" is 150 percent of the highest area of national rate permitted or, in the case of deregulation of interstate gas sales, is the average of the three highest prices provided in sales for resale in the South Louisiana area; or

(B) Abandonment of that share of the gas sold under said leases which is attributable to Williams, Inc., royalty interests.

In addition, the Settlement Agreement provides for Shell to deliver royalty gas to Williams, Inc., in the event abandonment authorization is granted pursuant to (B) above, and further to pay Williams, Inc. the sum of the royalty which would have been paid during 1974 if Shell's sales price during such period had been 45¢/Mcf, less royalty actually paid, plus the royalty due if the Commission approves (A) above, all as more fully spelled out in Article II of the Settlement Agreement attached to Shell's Petition as Appendix A.

Q. In your view, why should the Commission permit the Settlement Agreement to become effective by authorizing abandonment of Shell's Certificate and Rate Schedule insofar as it covers the Williams, Inc. royalty interest?

A. I am not an attorney and so cannot comment with any expertise on the legal questions involved. However, the

[77]

fact that a lawsuit is pending to cancel Shell's lease casts a cloud over any further expenditures of any substantial nature on this lease until the questions raised by the litigation are resolved.

Q. Would you comment on the legal risks and their implications for the pipeline purchaser and its consumer customers?

A. My understanding is that Shell's position in Docket No. 573-591 in the Civil District Court in the Parish of New Orleans, Louisiana, is that Shell is required only to pay royalty on the basis of the price which it is permitted to collect by the Federal Power Commission. The Williams, Inc. position is that the "market value" of the gas is some price higher than that permitted to be collected by the Commission and that they are entitled to damages measured by the difference between this royalty figure and the royalty actually paid, and in addition they are entitled to cancellation of Shell's lease by virtue of the alleged failure by Shell to make proper royalty payments.

Q. What would be the impact if Williams, Inc. were to prevail in the lawsuit?

A. If the Settlement Agreement is destroyed because the Commission refuses to grant abandonment of the Williams' interest, Williams, Inc. will claim the "market value" of the gas in Louisiana. In the State Court case, Williams, Inc. has alleged this value to be $1.40. If the Williams, Inc. royalty is calculated on this basis, the royalty would be 35¢ per Mcf on the 1952 lease, and 17.5¢ per Mcf on the 1934 lease. Shell's gas is being sold at two rate levels: the 31.11¢ Mcf ceiling rate for new gas in

Opinion 598 and the 59.88¢ per Mcf ceiling rate authorized by Opinion 699H. In addition to the payment of royalty, Shell's net revenue is further reduced by the 7¢ per Mcf severance tax charged by the State of Louisiana. Therefore, under these circumstances, Shell's operations would have to be severely curtailed and possibly the royalty and tax alone may exceed the revenue recovered.

Q. Why is this?

A. All of the costs of operating, developing and producing an oil and gas lease fall on the working interest or producer, which is Shell in this instance, and none on the royalty owner. Therefore, all of these costs must be

[78]

paid for out of revenue from the lease which is net to Shell. When the normal costs of the operation are considered, it is apparent that Shell will be unable to make further substantial expenditures to prevent early depletion of this lease.

Q. Has the risk of the State Court suit delayed any development on these leases?

A. Yes, very definitely. Shell has planned to drill a well on the 1934 lease, at a location in the N/2 SE/4 Section 30,

[79]

Township 17 South, Range 15 East, Terrebonne Parish. The well was approved for drilling by Shell's Management on June 19, 1973. When Williams, Inc. made their demands, which later culminated in the State litigation, this well was indefinitely postponed. The location has been prepared, and if, as and when the cloud of this litigation is removed, Shell will reevaluate the feasibility of drilling this well.

Q. What would be the result if Williams, Inc. prevailed in canceling the lease for failure to properly pay royalty?

A. Shell would be in a position of losing its entire investment in this lease through no fault of its own, because the Commission would not permit it to collect a price for its gas which is equal to the market value thereof, and would not approve a settlement which would have eliminated the problem.

Q. What are the damages claimed by Williams, Inc. against Shell for underpayment of royalty?

A. The Williams are claiming damages for past underpayment of royalties in the amount $197,689.49 through April 30, 1975.

Q. From the standpoint of the consumer, what would be the effect of such a decision by the Louisiana Court?

A. It is my understanding that the Williams, Inc. take the position that, should they prevail in the lawsuit, they will not be bound by Shell's contract to sell the gas to United, or by the Certificate of Public Convenience and Necessity issued by the Commission. They will therefore attempt to sell this gas on the intrastate market.

Q. Does the pipeline purchaser and its consumer customers have any recourse against this position?

A. It is my understanding that in Opinion No. 737, El Paso Natural Gas Company, Docket No. CP75-209, the Commission has held that a certificate of public convenience and necessity requires the continuation of a sale in the interstate market even after the termination of the lease. It is also my understanding that appeals are pending from this decision.

[80]

in the Court of Appeals.

Q. In other words, if the Settlement Agreement is destroyed by the refusal of the Commission to grant abandonment as to the royalty interests, the customers of United stand the risk of being deprived of 100 percent of the gas now being sold under Shell's Rate Schedule No. 202?

A. That is correct.

Q. Does that complete your testimony.

A. Yes, it does.

* * * *

[115]

MR. JOHNSON: Maybe we could just go off the record for a moment?

PRESIDING JUDGE: Very well.

Off the record.

(A discussion was held off the record.)

PRESIDING JUDGE: Back on the record.

We have been discussing problems of time, and believe with an expedited proceeding here, and problems of affording Shell whatever opportunity it thinks it needs to file additional cost data if it feels it needs such an opportunity.

Shell has apparently just seen the September 22nd Order this morning, and I don't want to be in a position of foreclosing Shell from producing whatever additional cost data it feels it has to produce.

Now, Pennzoil has expressed the view that it has presented its case and wishes the proceedings to be expedited as much as possible and is shooting for a briefing date of October the 10th, at least for the initial briefs, as I understand it.

MR. HACKERMAN: Yes, Your Honor.

PRESIDING JUDGE: Staff has expressed a view that if Shell is going to produce additional cost data that it will want some decent opportunity to examine and consider it and perhaps rebut it.

MR. JOHNSON: If Your Honor please, we are in a

[116]

quandary for several reasons. The Commission's initial Order said something about overall costs, without any explanation. Staff has made an indication here today that they feel that some additional cost data is required.

I would like to direct a question to the Staff through Your Honor about what additional cost data they believe to be required.

PRESIDING JUDGE: Can you respond to that, Ms. Province?

MS. PROVINCE: Yes, Your Honor. We would need the unit cost of gas based on the actual cost associated with the properties involved.

MR. JOHNSON: Well, I could ask further questions but I don't know whether it would be useful, Your Honor. I think we'll just have to take this request under advisement.

I would request that Your Honor allow us time within which to do that, whatever Your Honor feels is reasonable. We indicated off the record that Mr. Bruskotter has other commitments for all of next week.

PRESIDING JUDGE: Well, I'm prepared to sit today and tomorrow to try to conclude this case. I don't think that will be possible if you're going to have to go back and develop some cost figures.

MR. JOHNSON: That's correct, Your Honor. All of our cost records are, of course, in New Orleans. There's no way

* * * *

[119]

submission of whatever additional cost data Shell wishes to adduce in support of its position. That should be done in writing and should be in the hands of all the parties and the Commission Staff and myself by October the 2nd.

MR. JOHNSON: Your Honor, the mails are awfully uncertain. Could that be a mailing date?

PRESIDING JUDGE: Well, that's the problem with tying it in with the hearing date. I want to set a hearing date.

MR. JOHNSON: Oh, I see.

PRESIDING JUDGE: Well, I would just have to set it on the 8th in order to accommodate Commission Staff and put over my other cases starting on the 7th.

I will — let me strike the October 2nd date and put that the 3rd to give you an extra day.

MR. JOHNSON: Thank you, Your Honor.

PRESIDING JUDGE: And then we will resume this hearing on the 8th unless — well, we'll resume this hearing on the 8th then.

MR. JOHNSON: Your Honor, could I —

PRESIDING JUDGE: Let me — referring to the suggestion you put forth before, Mr. Johnson, that if you advise that you do not wish to submit any additional cost data it may not be necessary to hold another hearing in this matter.

MR. JOHNSON: Yes, Your Honor. We will undertake to advise you on the same date, the 3rd, if we feel that we

* * * *

[137]

EXHIBIT 2 (ADG-2)

Williams, Inc.
Whitney Building
New Orleans 70130

March 27, 1974

Certified Mail —

Return Receipt Requested

Shell Oil Company
P. O. Box 60193
New Orleans, Louisiana 70160

Pennzoil Company
900 Southwest Tower
Houston, Texas 77002
Attention: G. Bruce Mallum, Esq.

Pennzoil Producing Company
533 Westheimer, Suite 950
Houston, Texas 77027
Attention: Mr. J. T. Goodwyn, Jr.

Re: (1) Mineral Lease dated August 29, 1934 Between F. B. Williams Cypress Company, Limited (now Williams, Inc.), Lessor, and Shell Petroleum Corporation (now Shell Oil Company), Lessee

and

(2) Oil, Gas and Mineral Lease dated July 24, 1952, between Williams, Inc. and Mrs. Delphine C. Williams, et al., assigned to Shell Oil Company on January 4, 1955

Gibson Field — T17S-R15E
Terrebonne Parish, Louisiana

Gentlemen:

We submit herewith formal demand on behalf of Williams, Inc. as lessor and partial royalty owner and on behalf of the remaining royalty owners named on the attached schedule that the addressees comply with the obligations under the lease provisions under the captioned lease dated August 29, 1934 ("the 1934 lease") to pay to lessor or its assignees a gas royalty of "one-eighth (1/8) of the *value* thereof, calculated at the *market rate* prevailing at the well. . . ." We further make formal demand on behalf of Williams, Inc. as lessor and royalty owner that Shell Oil Company, as assignee of the captioned Oil, Gas and Mineral Lease dated July 24, 1952 ("the 1952 lease") comply with the lease provisions to pay the lessor a gas royalty of "one-fourth (1/4) of the value thereof, calculated at the market rate prevailing at the well. . . ."

[138]

Our investigation reflects that the value calculated at the market rate prevailing at the well as applied to recent production for purposes of royalty calculation should be no less than the following amounts for the following periods of time:

Period	Price Per MCF
October 1, 1971 — March 2, 1973	35 cents
March 3, 1973 — September 30, 1973	45 cents
October 1, 1973 — November 8, 1973	54 cents
November 9, 1973 — December 31, 1973	70 cents

We further demand that the current price of 70 cents per Mcf be applied for purposes of computation of royalty from

January 1, 1974 through the current period. We have calculated the underpayment of royalties due to the royalty owners reflected on the annexed schedule aggregates underpayment of royalties through December 31, 1973 from both leases of no less than $1,055,204.62, being $912,276.80 owed by Pennzoil Producing Co. and $142,927.82 by Shell Oil Company.

Williams, Inc. in its capacity as successor to all rights of the original lessor under the 1934 lease and as lessor under the 1952 lease further demands cancellation and termination of the leases in view of the failure of the lessee and its related parties to comply with the obligations under the leases with respect to the payment of proper royalties to the proper royalty owners.

We withdraw herewith the demand made in our letter of June 7, 1973 on behalf of Williams, Inc. in order to avoid any confusion. We make the foregoing demand on behalf of Williams, Inc. and on owners of royalty under the 1934 lease, who have authorized Williams, Inc. to represent them in asserting their demands for royalty payments.

Yours very truly,

WILLIAMS, INC.

By: FRANK B. WILLIAMS
Frank B. Williams

* * * *

[143]

EXHIBIT 4 (ADG-4)
CIVIL DISTRICT COURT
IN AND FOR
THE PARISH OF ORLEANS
STATE OF LOUISIANA

NO. .... DIV. .... DOCKET ....

SHELL OIL COMPANY
AND
PENNZOIL PRODUCING COMPANY
VS.
WILLIAMS, INC., ET AL

FILED: ....
Deputy Clerk

PETITION FOR TEMPORARY RESTRAINING ORDER, PRELIMINARY AND PERMANENT INJUNCTION, AND DECLARATORY JUDGMENT

The petition of:

(1) SHELL OIL COMPANY, a corporation organized under the laws of the State of Delaware, but qualified to do business in the State of Louisiana, which maintains its registered office in the State of Louisiana at 1300 Hibernia Building, New Orleans, Louisiana, (hereinafter referred to as "Shell"); and

(2) PENNZOIL PRODUCING COMPANY, a corporation organized under the laws of the State of Delaware, but qualified to do business in the State of Louisiana, which maintains its registered office in the State of Louisiana at 1300 Hibernia Building, New Orleans, Louisiana, (hereinafter referred to as "Pennzoil"), respectfully represents that:

I.

Shell is an integrated oil company engaged in the production and refining of all forms of petroleum and hydrocarbons and is the successor in interest to its predecessors, Shell Petroleum Corporation and Shell Oil Company, Incorporated.

II.

Pennzoil is a corporation engaged in the exploration, production and development of oil and gas properties and mineral prospects and is the successor in interest to its predecessor, Union Producing Company.

[144]

III.

The principal defendant herein, WILLIAMS, INC., is a corporation organized under the laws of the State of Delaware, but qualified to do business in the State of Louisiana, which maintains its registered office in the State of Louisiana and principal business establishment at 1323 Whitney Building, New Orleans, Louisiana. Williams, Inc. is the successor in interest to its predecessor, F. B. Williams Cypress Company, Limited.

* * * *

[146]

VI.

The parties named in Articles III and IV collectively and individually own beneficial interests in the oil, gas and mineral leases hereinafter more particularly described and as such they are now, and they and their predecessors for many years past have been, the recipients of regular royalty payments representing a portion of the proceeds of mineral production from the Gibson Field in the Parish of Terrebonne.

VII.

By instrument dated August 29, 1934, F. B. Williams Cypress Company, Limited and C. S. Williams, Trustee, as lessors, granted to Shell Petroleum Corporation, as lessee, an oil, gas and mineral lease, designated as No. 30321, formerly No. L 3357, (hereinafter referred to as the "1934 Williams Lease"), registered in Conveyance Book 103, folio 274 of the records of the Parish of Terrebonne, which embraced 61,442 acres situated in five South Louisiana parishes and provided for a five year primary term to commence with a selection date set forth therein. The 1934 Williams Lease also stipulated that on or before August 29, 1935, the original selection date, the lessee should designate or select areas suitable for mineral development as to which drilling operations should be commenced or rentals paid in accordance with the lease

[147]

terms; that such areas should be treated as development units thereafter; and that the remainder of the leased property was subject to be released by the lessee. By agreement of the parties the original selection date was extended to March 1, 1937, and prior thereto the lessee selected 3,508.81 acres in the Parish of Terrebonne, known as Area "K", which forms a portion of the Gibson Field in said parish. Thereafter, the 1934 Williams Lease was maintained in force and effect according to its terms and on the 13th day of October, 1937, a producing oil well designated as Shell Pelican No. 2 was completed on Area "K". The lease has since been continuously maintained in force and effect by production, and the defendants herein and their predecessors have regularly received and accepted royalty payments made to them conformably to the provisions of the lease.

VIII.

Paragraph 4 of the 1934 Williams Lease (a copy whereof is annexed hereto and made part hereof as Exhibit A), stipulates in part that: "Lessee agrees as to royalties: * * * to pay Lessor for gas and/or casinghead gas produced and saved by Lessee from the land hereby leased (a) *one-eighth* (1/8) *of the value thereof, calculated at the market rate prevailing at the well,* * * *".

IX.

Shell Petroleum Corporation, as lessee under the 1934 Williams Lease, had stringent development obligations, yet was without a market for any gas it might produce and had no facilities to transport such gas to a market, if any had existed. Consequently, Shell was obliged to arrange for the development

[148]

of the leased acreage for gas and the marketing of any gas that might be thereby produced. By instrument dated December 24, 1941, styled "Gibson Area Agreement" (a copy whereof is annexed hereto and made part hereof as Exhibit B) Shell Oil Company, Incorporated, successor to Shell Petroleum Corporation, and Union Producing Company (hereinafter referred to as "Union"), predecessor to Pennzoil, agreed that Union would drill two gas wells on acreage located in Township 17 South, Range 15 East, in the Parish of Terrebonne, lying within the area selected under the 1934 Williams Lease. These wells were to be drilled pursuant to the explicit agreement between said parties that Union would have such wells connected to a 10 inch pipe line which was to be constructed by United Gas Pipe Line Company (hereinafter referred to as "United") under a certain gas sales contract between Union and United and to the further agreement by Union to purchase

said two wells from Shell Oil Company, Incorporated, if they were completed as gas wells with a capability of producing gas in paying quantities. At that time United operated the only pipe line in the area and thus provided the only possible market for such gas. The Gibson Area Agreement further took express cognizance of the fact that under the aforesaid gas sale contract between Union and United dated December 23, 1941, (hereinafter referred to as the "1941 Gas Sale Contract", a copy whereof is annexed hereto and made part hereof as Exhibit C) gas produced by Union in stipulated quantities from the Shell leases (including the 1934 Williams Lease) in the Gibson Field, would be sold and delivered to United by Union, as sublessee of Shell Oil Company, Incorporated. Under the Gibson Area Agreement Shell Oil Company, Incorporated, was to transfer its gas rights to Union subject to the reservation of an overriding royalty of 1/8th of 8/8ths of any distillate, condensate and other liquid hydrocarbons produced from gas wells, with such royalty to be increased to 3/16ths of 8/8ths after the fourth year of the first gas deliveries, an overriding royalty on

[149]

gasoline extracted from gas of 3/32nds of 8/8ths thereof, and an overriding royalty on gas of 1/8th of the value at the well of gas produced from gas wells, *to be increased to 3/16th of the value at the well of gas produced from gas wells after the fourth year of the first gas deliveries.* For the purpose of computing the reserved overriding royalty, the Gibson Area Agreement further provided that the value of the gas was to be the price to be received by Union from United under the 1941 Gas Sale Contract; and after the termination of said contract, the value of such gas was to be that agreed upon by the parties from time to time "determined by the prevailing market price of gas at the

well in the Central part of South Louisiana Area". Finally, the Gibson Area Agreement provided that Shell Oil Company, Incorporated, reserved the right to purchase from Union any gas produced from the affected leases for production of oil upon payment of a price "equal to the market value of said gas at the time taken as fixed and established under the provisions" set forth above, but subject to a maximum limit of 500 million cubic feet during any one calendar year.

X.

By a sublease (hereinafter referred to as "Sublease") dated December 29, 1942, effective as of December 24, 1941, registered in Conveyance Book 134, folio 463, of the records of the Parish of Terrebonne (a copy of which Sublease is annexed hereto and made part hereof as Exhibit D) Shell Oil Company, Incorporated, subleased to Union its rights in the gas and certain other liquid hydrocarbons produced and to be produced under the 1934 Williams Lease and other leases by different lessors in the Gibson Field, subject to the reservation of the overriding royalties set forth in Article IX. The Sublease was approved by Williams, Inc. on its own behalf and on behalf of its royalty distributees by a letter dated

[150]

December 30, 1941, (a copy of which letter is annexed hereto and made part hereof as Exhibit E). Thereafter by letter dated January 21, 1943 (a copy of which letter is annexed hereto and made part hereof as Exhibit F) the royalty distributees took cognizance of Williams, Inc.'s approval of the Sublease and designated Williams, Inc. to receive for itself and for the other named defendants herein, or their predecessors in title, as royalty distributees, payment of all gas royalties and other payments under the 1934 Williams Lease.

XI.

The parties to the 1941 Gas Sale Contract took cognizance of the fact that United operated a pipe line from the Lirette Field and from other fields in the Parish of Terrebonne to a point near Covington, Louisiana, and that Union contemplated acquisition of gas rights from Shell Oil Company, Incorporated, in the Gibson Field pursuant to an obligation to drill additional wells in the Gibson Field in order to enable Union to supply a portion of United's requirements. Under the terms of the 1941 Gas Sale Contract, Union agreed to sell and United agreed to buy "merchantable gas which may be produced from the lands and leaseholds under which Seller (i.e., Union) owns or shall hereafter own, and from the lands and leaseholds of others from whom Seller (i.e., Union) is now purchasing or may hereafter purchase gas in the Gibson Field in Terrebonne Parish, Louisiana", and Buyer (i.e., United) was to "have the right and privilege from time to time, at any time during the term of this agreement, of purchasing all of the merchantable gas produced from said lands and leaseholds • • •".

XII.

The 1941 Gas Sale Contract stipulated for the payment by United to Union of a price of three cents per thousand cubic feet ("MCF") of gas plus a tax allowance from the date of first delivery to June 30, 1945, and a minimum price of 4 cents plus tax allowance from July 1, 1945, to June 30, 1950, but determinable according to a stipulated formula, which was

[151]

dependent upon a weighted average price for said gas received by United's utility customers. Pursuant to an agreement between Union and United dated March 18, 1949,

the contract term was extended to June 30, 1960; oil well gas (i.e., gas produced along with crude oil from an oil well) was included within the gas to be taken by United under the 1941 Gas Sale Contract, and the price of said gas was increased to 10 cents per MCF, plus one-half of new or additional taxes imposed by law upon Union after June 30, 1950.

XIII.

On or about October 30, 1959, Union and United entered into a second gas sales contract (No. 2679, hereinafter referred to as the "1959 Gas Sale Contract", a copy whereof is annexed hereto and made part hereof as Exhibit G) which became effective by its terms on November 1, 1959, which expressly superseded the 1941 Gas Sale Contract, and which further provided that the contract term would expire on November 1, 1979. The 1959 Gas Sale Contract required United to take or pay for, during each contract year, quantities of gas at least equal to an annual minimum quantity defined as 36.5 million cubic feet of gas per contract year for each billion cubic feet of Union's gas reserves (i.e., the estimated total quantity of recoverable gas owned by Union and contained in its reservoirs underlying the subject leaseholds). The 1959 Gas Sale Contract further established the price payable for gas sold and delivered thereunder by Union to United at the following rates: 21.25 cents per MCF until May 1, 1964; 22.25 cents thereafter until May 1, 1969; 23.25 cents thereafter until May 1, 1974; and 24.25 cents thereafter until November 1, 1979, plus a tax reimbursement in connection therewith, with the basic price for the periods from May 1, 1969, through November 1, 1979, subject to redetermination on the basis of an average of the three highest unit prices being paid within a six parish area under contracts between bona fide gas pipe line companies and producers. The 1959 Gas Sale Contract stipulated that it was made subject to any present and

[152]

future valid orders, rules, and regulations of any federal or state regulatory body having jurisdiction.

XIV.

Under the rationale of *Phillips Petroleum Co.* v. *Wisconsin,* 347 U.S. 672 [1954] decided on June 7, 1954, the Supreme Court of the United States recognized the power of the Federal Power Commission to regulate the price to be charged at the wellhead by gas companies to interstate pipe lines for resale in interstate commerce. Accordingly, the price charged by Union to United for gas sold after June 7, 1954, was governed by regulation of the Federal Power Commission, rather than by the applicable provision of the 1941 and 1959 Gas Sale Contract.

XV.

By an instrument dated July 24, 1952, registered in Conveyance Book 217, folio 18, of the records of the Parish of Terrebonne, Williams, Inc. granted an oil, gas and mineral lease (No. L-12327, hereinafter referred to as the 1952 Williams Lease, a copy whereof is annexed hereto and made part hereof as Exhibit H) covering 20 acres out of Section 36, T 17 S, R 15 E, Terrebonne Parish, unto Mrs. Delphine C. Williams, Frank B. Williams, Mrs. Elizabeth Williams Zorthian, Mrs. Leila Moore Williams, L. Kemper Williams, Mrs. Katharine Williams Tremaine, Laurence H. Williams, and Mrs. Lucille Williams Mayfield, providing for a five year primary term and royalties of one-sixth on oil and gas. The aforenamed lessees assigned the 1952 Williams Lease to Shell, and the said lease was amended by an agreement between the lessees and Shell, dated January 24, 1955, to increase the royalty fraction stipulated to be paid to the original lessees in said lease from an undivided one-sixth to an undivided one-fourth. The royalty

fraction as thus increased was to be applied, with respect to gas, to *"the value thereof, calculated at the market price prevailing at the well"*.

[153]

By an agreement (hereinafter referred to as the "1944 Shell Gas Sale Contract", a copy whereof is annexed hereto and made part hereof as Exhibit I) dated October 5, 1944, Shell Oil Company, Incorporated, and Barnsdall Oil Company agreed to sell and United agreed to buy "merchantable gas which may be produced from the lands and leaseholds which Seller (i.e., Shell Oil Company, Incorporated, and Barnsdall Oil Company) owns and shall hereafter own and from the lands and leaseholds of others from whom Seller is now purchasing or may hereafter purchase gas in the Gibson Field" and Buyer (i.e., United) was to "have the right and privilege from time to time, at any time during the term of this agreement, of purchasing all of the merchantable gas produced from said lands and leaseholds . . .",

XVII.

The 1944 Shell Gas Sale Contract stipulated for the payment by United to Shell Oil Company, Incorporated, and Barnsdall Oil Company of a price of 3 cents per MCF of gas plus a tax allowance from the date of first delivery to June 30, 1945, and a minimum price of 4 cents plus tax allowance from July 1, 1945, to June 30, 1950, but determinable according to a stipulated formula which was dependent upon a weighted average price for said gas received by United's utility customers. Gas produced in connection with the development of oil wells under the 1934 Williams Lease was sold pursuant to the 1944 Shell Gas Sale Contract but in order to specifically so provide Shell Oil Company, Incorporated, and Barnsdall Oil Company amended the 1944 Shell Gas Sale Contract by agreement

dated March 1, 1949, pursuant to which the contract term was extended to June 30, 1960 and pursuant to which the parties thereto agreed that "Oil Well Gas" or casing-head gas could be delivered in order to supply a portion of the requirements of United's Lirette-Mississippi Pipe Line under the terms of the 1944 Shell Gas Sale Contract; similarly,

[154]

the price to be paid by United to Shell Oil Company, Incorporated, and Barnsdall Oil Company was increased to 10 cents per MCF plus one-half of any additional taxes imposed by law after June 30, 1950.

XVIII.

On or about May 1, 1959, Shell and United entered into a second gas sales contract (hereinafter referred to as the "1959 Shell Gas Sale Contract", a copy whereof is annexed hereto and made part hereof as Exhibit J) which became effective by its terms on May 1, 1959, which expressly superseded the 1944 Shell Gas Sale Contract and further provided that the contract term would expire on April 30, 1979. The 1959 Shell Gas Sale Contract required United to take or pay for, "during each contract year (from a portion of Shell's natural gas production in the Gibson Field including, with production from other sources, natural gas produced upon the twenty acre tract affected by the 1952 Williams Lease) quantities of gas at least equal to an annual minimum quantity defined as 36.5 million cubic feet of gas per contract year for each billion cubic feet of Shell's gas reserves. The 1959 Shell Gas Sale Contract further established the price payable for gas sold and delivered thereunder by Shell to United at the following rates: 21.25 cents per MCF until May 1, 1964; 22.25 cents thereafter until May 1, 1969; 23.25 cents thereafter until

May 1, 1974, and 24.25 cents thereafter until April 30, 1979, plus a tax reimbursement in connection therewith, with the basic price for the periods from May 1, 1969 through April 30, 1979 subject to redetermination on the basis of an average of the three highest unit prices being paid within a six parish area under contract between bona fide gas pipe line customers and producers. The 1959 Shell Gas Sale Contract stipulated that it was made subject to any present and future valid orders, rules, and regulations of any federal or state regulatory body having jurisdiction.

[155]

XIX.

As stated hereinabove, United was the purchaser of all the natural gas produced by Pennzoil and its predecessor, Union, under the 1934 Williams Lease, and said gas was received and transported by United in its Lirette-Mississippi, interstate pipe line pursuant to the 1941 Gas Sale Contract. Similarly, gas produced by Shell under the 1934 and 1952 Williams Leases was sold by Shell as a portion of its Gibson Field production to United and likewise was received and transported by United in its Lirette-Mississippi, interstate system in consequence whereof as a matter of fact and law all of said gas produced by Pennzoil and Shell under the 1934 and 1952 Williams Leases was dedicated to United's interstate system. Under the rationale of *Phillips Petroleum Co.* v. *Wisconsin,* 347 U.S. 672 (1954), decided by the Supreme Court of the United States on June 7, 1954, gas producing companies engaged in the sale of gas to interstate pipe line companies for resale were classified as natural gas companies within the meaning of the Natural Gas Act; and accordingly the Federal Power Commission, under the supremecy clause of the United States Constitution, was invested with inherent power and jurisdiction to regulate the price to be charged at the well-

head for gas sold by natural gas companies to interstate pipe lines for resale in interstate commerce. Accordingly, the price for old gas sold by Pennzoil and Shell and their predecessors after June 7, 1954, was governed by the regulations of the Federal Power Commission rather than by the applicable provisions of the gas sales contracts in effect at that time.

XX.

The sale of natural gas which gives rise to the controversy described herein has been subjected to the regulatory control of the Federal Power Commission under the terms of the Natural Gas Act, 15 U.S.C., §§717-717W (1938) and the rationale of the *Phillips* decision, *supra.* Following the *Phillips*

[156]

decision, the Federal Power Commission issued "grandfather" certificates covering sales of gas in existence on June 7, 1954, allowing prices collected on that date to continue to be collected. On or about the 28th day of September, 1960, the Federal Power Commission established "guideline" prices for the purpose of controlling wellhead prices of natural gas. *Statement of General Policy No. 61-1, 24 FPC 818 (1960).* During this period, and prior to the advent of area rate regulation, the Federal Power Commission allowed producers to collect prices based on the applicable "guideline" price on individual company bases adjudicated before the Commission. During this period, many natural gas producing companies entered settlements involving their wellhead prices of natural gas. On or about the 25th day of September, 1968, the Federal Power Commission issued its first area rate decision for the Southern Louisiana Area. Opinion No. 546, 40 FPC 530 (1968). Shortly thereafter, on or about the 27th day of October,

1970, the Federal Power Commission authorized producers to collect, subject to refund, rates in excess of those established in Opinion No. 546. Order No. 413, 44 FPC 1316 (1970). On or about July 16, 1971, the Federal Power Commission issued its second area rate decision for the Southern Louisiana Area. Opinion No. 598, 46 FPC 86 (1971). The ceiling prices established in Opinion No. 598 are presently in effect for the Southern Louisiana Area, although this opinion is being challenged on judicial review and therefore is not final. *Mobil Oil Corp.* v. *F.P.C.*, No. 73-437, et al. (U.S. Sup. Ct.). Accordingly, from June 7, 1954 through the present date, the gas produced, sold and delivered from the 1934 Williams Lease and the 1952 Williams Lease has been subject to Federal Power Commission regulation, and Pennzoil, Shell, and their predecessors in interest from the inception of production under such leases have continually sold and delivered the natural gas produced therefrom to United's interstate pipe line system for resale in interstate commerce.

[157]

Thus, at all times subsequent to the inception of regulations by the Federal Power Commission of the wellhead price of natural gas transported and sold in interstate commerce, the natural gas produced by Pennzoil and Shell and their predecessors, under the 1934 Williams Lease and the 1952 Williams Lease, has been "jurisdictional gas" subject to regulation and control as to price by the Federal Power Commission.

XXI.

As stated hereinabove, when initial gas production was established under the 1934 Williams Lease there was no pipe line or gas gathering system established and in operation in the Gibson Field. Consequently, a motivating cause for the execution of the Sublease affecting gas rights thereunder was to obtain an assured market for the gas reserves to be developed under the 1934 Williams Lease. The prices stipulated in the 1941 Gas Sale Contract between Union and United constituted the best and in fact the only "market price" obtainable for such gas at that time. Moreover, such gas was originally dedicated for sale and transportation in interstate commerce and since 1954 has been subject to regulation and control as to price by the Federal Power Commission. From 1954 until the present date Williams, Inc., on its own behalf and as agent for the other defendants herein or their predecessors, has been paid royalties computed conformably to Federal Power Commission regulated prices, which have been increased from time to time since the inception of such regulation pursuant to appropriate orders of the Federal Power Commission; and defendants have been the beneficiaries of such price increases.

XXII.

By letter agreements dated May 23, 1973, and May 24, 1973, (copies whereof are annexed hereto and made part hereof as Exhibits K and L) Shell and Pennzoil, respectively, amended the 1959 Shell and Pennzoil Gas Sale Contracts to add a provision that if the Area Rate (i.e., the applicable rate by order of the Federal Power Commission for gas produced from the leasehold area) should be greater than the contract price

[158]

including tax reimbursement and Btu content adjustment, then United should pay Pennzoil and Shell an amount equal to the Area Rate. The agreement between Shell and United likewise increased the base price for the last two periods

of adjustment from 23.25 and 24.25 cents to 26.05 and 27.05 cents, respectively. Both letters added a clause providing that in the event that the Federal Power Commission ceases to regulate the price of "jurisdictional" natural gas produced in the Gibson Field and sold in interstate commerce, the price to be paid Pennzoil and United shall be based upon a fraction taking into consideration the highest prices paid to the South Louisiana area.

XXIII.

Notwithstanding the foregoing, by letter dated March 27, 1974, (hereinafter referred to as the "Williams Letter", a copy whereof is annexed hereto and made part hereof as Exhibit M) addressed to petitioners and Pennzoil Company, Williams, Inc. on its own behalf and on behalf of the other defendants herein asserted a formal demand for $1,055,204.62 for gas royalties allegedly due under the 1934 Williams Lease and the 1952 Williams Lease computed at unit prices per MCF for various periods between October 1, 1971, and December 31, 1973, from 35 cents to 70 cents, and 70 cents after January 1, 1974. The total demand consisted of $912,276.80 claimed to be due by Pennzoil and $142,927.82 claimed to be due by Shell. The Williams Letter further demanded cancellation and termination of the 1934 Williams Lease and the 1952 Williams Lease.

XXIV.

Paragraph 12 of the 1934 Williams Lease provides in part that:

> "In the event Lessor considers that Lessee has not complied with all its obligations hereunder, both express and implied, Lessor shall notify Lessee in writing, setting out specifically in what respects Lessee has breached this contract. Lessee shall then have sixty (60) days after

> receipt of said notice within which to meet or commence to meet all or any part of the breaches alleged by Lessor. The service of said notice shall be precedent to the bringing of any action by Lessor on said lease for any cause. Neither the service of said notice nor the doing of any acts by Lessee aimed to meet all or any of the alleged breaches shall be deemed an admission or presumption that Lessee has failed to perform all its obligations hereunder."

and paragraph 5 of the 1952 Williams Lease provides in part that:

> "After production of oil, gas or other minerals in paying quantities, no default or breach of any expressed or implied obligation of Lessee shall work a forfeiture or cancellation of this lease unless and until Lessee shall have been notified in writing of the facts relied upon by Lessor as constituting a breach and Lessee given sixty (60) days after receipt of such notice to comply therewith."

The sixty-day period set forth in both lease provisions has not yet expired.

XXV.

Both petitioners and defendants agree that the measure for determining the royalty obligation due is governed by the phrases "one-eighth (1/8) of the value thereof, calculated at the *market rate* prevailing at the well" and "one-fourth (1/4) of the value thereof, calculated at the *market price* prevailing at the well" contained in the 1934 and 1952 Williams Leases, respectively. Defendants contend that the "market rate" or "market price" for the years in question is as follows:

Period	Price Per MCF
October 1, 1971 — March 2, 1973	35 cents
March 3, 1973 — September 30, 1973	45 cents
October 1, 1973 — November 8, 1973	54 cents
November 9, 1973 to date	70 cents

Defendants, however, set forth no theoretical basis for their conclusion. Petitioners contend, on the other hand, that the proper measure of the "market rate" or "market price" for pur-

[160]

poses of determining the royalties due under the 1934 and 1952 Williams Leases is no greater than the price permitted pursuant to the regulations of the Federal Power Commission.

XXVI.

Not only did Pennzoil and Shell and their predecessors diligently discharge their lease obligations to market the natural gas produced in the Gibson Field but they also insured the best price obtainable for such gas by including in their contracts price escalation clauses to be based in one instance on the highest price received by United's utilities customers and in the other on an average of the three highest unit prices being paid within a six parish area of South Louisiana under contracts between bona fide gas pipe line companies and producers. Had not the Federal Power Commission asserted jurisdiction over the gas produced in the Gibson Field, the price obtainable for such gas and therefore the price upon which royalty under the 1934 and 1952 Williams Leases would be determinable would have been the highest obtainable in the market for

such natural gas produced under the aforesaid leases at any point in time. Nonetheless, the implications of the 1954 *Phillips* decision, *supra,* and the subsequent area rate regulations superseded the contract provisions and therefore not only govern the price received by Pennzoil and Shell but constitute the "market rate" or "market price" for purposes of determining royalty under both the 1934 and the 1952 Williams Leases.

XXVII.

As alleged in paragraph X defendants either approved or took cognizance of the approval of the assignment or sublease of the 1934 Williams Lease to Union and were aware that natural gas produced thereunder was being sold and was to be sold in the interstate market.

XXVIII.

Gas sold under the 1934 and 1952 Williams Leases to United was thereby dedicated to the interstate market and can

[161]

be sold in no other market absent abandonment proceedings before the Federal Power Commission. Such gas is thus salable for all practical purposes only in the interstate market and any comparison of "market rate" or "market price" must be restricted to the interstate market for the Gibson Field; in that respect the "market rate" or "market price" is the regulated rate established by the Federal Power Commission for the Gibson Field. Pennzoil, Shell and the defendants have continuously been paid on the basis of the regulated price.

XXIX.

Natural gas, unlike petroleum or liquid hydrocarbons, has historically been sold under long term contracts primar-

ily because of the extensive capital expenditures necessary to develop processing plants, gathering systems and pipe lines. In order to assure a fair rate of return on investment, prices specified in gas contracts, even those containing escalation clauses, must be fairly ascertainable at the inception of such contracts. Since the amount of royalty payable to lessors is also an important element in pricing, it is imperative to the economic viability of the natural gas industry and inherent in the history of long term natural gas sales contracts that the measure of the royalty due (i.e. "market rate" or "market price" in this instance) be governed by the prevailing "market price" or "market rate" at the time when gas developed pursuant to a mineral lease is initially dedicated to a gas sales contract.

XXX.

If at the time gas produced under a mineral lease is initially sold the price specified in the contract for the sale of such gas is equal to or greater than the then prevailing "market rate" or "market price" at the wellhead, the contract provisions as to price should govern.

[162]

XXXI.

Gas produced under the 1934 and 1952 Williams Leases is sold to the interstate market and in each instance in which such gas has been sold Shell, Pennzoil and their predecessors obtained the highest "market rate" or "market price" obtainable at that moment in time. Thus, the pricing provisions, including escalation provisions, in each such gas sale contract should govern the measure of the royalty obligation due the defendants.

XXXII.

Petitioners have at all times remitted royalties to defendants and their predecessors on the basis of the proper measure of that obligation and for that reason request a declaration by this Honorable Court that petitioners' interpretaticn of the phrases "market rate" and "market price" in the subject leases is correct, that petitioners have properly discharged their royalty obligations to defendants, and that the 1934 Williams Lease and the 1952 Williams Lease are still in force and effect, notwithstanding the demands made by defendants in the Williams Letter.

XXXIII.

In the event that the Court should conclude that petitioners' interpretation of the phrases "market rate" and "market price" in the subject leases is incorrect and that as a result petitioners have not remitted to defendants royalties measured on a proper basis, which petitioners deny, nevertheless petitioners are entitled to remit such royalties for any periods in question in compliance with the final judgment entered in these proceedings in order to preserve in force and effect the 1934 Williams Lease and the 1952 Williams Lease; petitioners are amply solvent and would be able to make such payment, and petitioners, in the alternative, request a declaration by this Honorable Court that, upon such payment, such leases continue in force and effect, notwithstanding the demands made by defendants in the Williams Letter.

[163]

XXXIV.

Petitioners aver that a good faith justiciable controversy exists over the measure of their royalty obligations to defendants; that for that reason the mineral leases in

question should not be cancelled; that cancellation of the 1934 and 1952 Williams Leases would result in irreparable harm, damage and loss to petitioners for such cancellation would result in a loss of leasehold interest and natural gas production that would require an assessment of damages which petitioners aver would be extremely difficult if not impossible to ascertain, since the total amount of natural gas recoverable by petitioners can only be determined through maintenance of the leases. Moreover, such loss of production would result in petitioners thereafter being unable to meet contracts for the sale of natural gas to United and other parties; and that payment at this time of the additional sums demanded would be unrecoverable in the eventuality that this Court adopts the interpretation of the phrases "market rate" and "market price" advocated by petitioners.

XXXV.

Accordingly petitioners aver that they fear immediate and irreparable harm, loss and damage and that they will be unlawfully deprived of their rights and that they are without any adequate remedy at law in the premises; and that it is necessary in order to protect petitioners' rights that this Honorable Court issue a temporary restraining order and thereafter an injunction prohibiting, restraining and enjoining defendants, their officers, agents, representatives, attorneys and employees, and all other persons acting in concert or participation therewith, from hindering the orderly prosecution of this suit, and from taking any action to alter or disturb the contractual status now existing among the parties pursuant to the 1934 and 1952 Williams Leases or either of them or to cancel, terminate or assert cancellation or termination of the 1934 and 1952 Williams Leases, or either of them.

[164]

XXXVI.

Petitioners fear that during the pendency of this proceeding defendants, their officers, agents, representatives, attorneys, and employees, and other persons acting in concert or participation therewith, will attempt to cancel or terminate the 1934 and 1952 Williams Leases and divest this Honorable Court of jurisdiction to decide this controversy and so deprive petitioners of their rights in the premises.

XXXVII.

Due to the fact that defendants, their officers, agents, representatives, attorneys and employees and all other persons acting in concert or participation with them, may accomplish the purpose stated in said order to the immediate and irreparable harm, loss and damage of petitioners, it is necessary, in order to protect petitioners' rights, that a temporary restraining order issue herein before notice and hearing in the form and substance mentioned above upon petitioners' furnishing such bond as the Court may direct.

WHEREFORE, petitioners pray that defendants be served with a copy of this petition and that:

1. Upon petitioners furnishing a bond in an amount to be fixed by the Court, a temporary restraining order issue herein according to law directed to defendants and restraining, enjoining and prohibiting defendants, their agents, employees and all other persons, firms or corporations acting or claiming to act in their behalf, from hindering the orderly prosecution of this suit, and from taking any action to alter or disturb the contractual status now existing among the parties pursuant to the 1934 and 1952 Williams Leases or either of them or to cancel, terminate

or assert the cancellation or termination of the 1934 and 1952 Williams Leases, or either of them.

2. Defendants be duly ordered to show cause on a day and at a time to be fixed by this Court, why a preliminary injunction

[165]

in the form and of the substance of the temporary restraining order prayed for above should not be issued herein and that after due proceedings be had, there be judgment herein making the said rule absolute and that a preliminary and permanent injunction be issued in the form and of the substance of the temporary restraining order prayed for herein.

3. An attorney be appointed to represent the defendants who are nonresidents of the State of Louisiana or absentees, and that this proceeding be conducted contradictorily against such attorney.

4. Defendants be duly cited to appear and answer this petition, and after legal delays and due proceedings had, there be judgment herein in favor of petitioners Shell and Pennzoil, and against defendants, perpetuating and making permanent the preliminary injunction prayed for above.

5. There be further judgment herein declaring that petitioners' interpretation of the phrases "market rate" and "market price" in the subject leases is correct, that petitioners have properly discharged their royalty obligations to defendants on the basis of the Federal Power Commission regulated rate in effect for the periods in question and may continue to so discharge such obligations while any regulated rate established by the Federal Power Commission remains in effect, and that the 1934 Williams Lease and the 1952 Williams Lease are still in force and effect, notwithstanding the demands made by defendants in the Williams Letter.

6. Alternatively, in the event that the Court should conclude that petitioners' interpretation of the phrases "market rate" and "market price" in the subject leases is incorrect and that as a result petitioners have not remitted to defendants royalties measured on a proper basis, that there be judgment herein declaring that petitioners are entitled to remit such

[166]

payment, that the 1934 Williams Lease and the 1952 Williams Lease continue in force and effect, notwithstanding the demands made by the defendants in the Williams Letter.

7. Such further or supplemental relief be granted as may be necessary or proper.

8. The Court grant petitioners general and equitable relief and award petitioners all costs of this proceeding.

LEMLE, KELLEHER, KOHLMEYER & MATTHEWS

By: ....

Harry B. Kelleher,
Murphy Moss and
Ernest L. Edwards
1800 First National Bank of Commerce Building
New Orleans, Louisiana 70112
Telephone: 586-1241

SHELL OIL COMPANY:
Alvin B. Gibson

PENNZOIL PRODUCING COMPANY:
G. Bruce Mallum
A. Duncan Gray, Jr.
Richard B. Wilkins

* * * *

[169]

EXHIBIT 5 (ADG-5)

CIVIL DISTRICT COURT
FOR THE
PARISH OF ORLEANS
STATE OF LOUISIANA

NO. 573-581 DIVISION "A" DOCKET 5

SHELL OIL COMPANY and
PENNZOIL PRODUCING COMPANY

vs.

WILLIAMS, INC., *et al.*

FILED: ....
Deputy Clerk

ANSWER AND RECONVENTIONAL DEMAND

Now into Court, through undersigned counsel, come Williams, Inc. and Frank B. Williams, individually and as Executor of the Succession of Mrs. Delphine C. Williams, Laurence M. Williams, The Kemper and Leila Williams Foundation, Lucille W. Mayfield Trusts for Ann Marsak and for Alec Andrew Johnson, Ann Marsak, Alec Andrew Johnson, Mrs. Katherine W. Tremaine, Elizabeth Williams Trust, Elizabeth Williams, Mrs. Elizabeth Campbell Brooks, Whitney L. Brooks, Trustee for Anne Campbell, Alan Adams Campbell, and Valley Bank & Trust Company, Executor u/w Holbrook Campbell, the defendants named herein ("respondents"), and for answer to the petition of plaintiffs, Shell Oil Company ("Shell") and Pennzoil Producing Company ("Pennzoil"), state:

1.

Respondents admit that Shell is the successor in interest of Shell Petroleum Corporation and that Shell is engaged in the production of oil and gas. All other allegations of Paragraph I are denied for lack of sufficient information and knowledge sufficient to justify belief.

2.

The respondents admit the allegations of Paragraph II.

3.

The respondents admit the allegations of Paragraph III.

4.

The respondents admit the allegations of Paragraph IV.

[170]

5.

The respondents admit the allegations of Paragraph V.

6.

The allegations of Paragraph VI are admitted, except that the respondents affirmatively assert that the royalty payments which have been received are less than the amount required by the leases and less than the amounts which have been demanded by the respondents.

7.

The respondents deny that the 1934 Williams Lease has been continuously maintained in force and effect. The respondents further deny that the royalty payments have been made in conformity with the provisions of the lease; rather, respondents aver that the royalty payments made since October 1, 1971, and possibly prior thereto, were in violation of the lease and, as hereinafter set forth, created a basis for cancellation of the lease. The lease has been

cancelled by Williams, Inc. in accordance with its terms and is no longer in effect. Respondents further aver that releases of acreage from the lease subsequent to March 1, 1937 reduced the leased acreage to 1,864.71 acres. All other allegations of Paragraph VII are admitted.

8.

The respondents admit the allegations of Paragraph VIII.

9.

The respondents deny the allegations of Paragraph IX for lack of information sufficient to justify a belief, except that respondents admit that Shell had the obligation to develop the 1934 Williams Lease. Williams, Inc. affirmatively avers that it was not a party to any election made by Shell as to development of markets for gas or in arrangements or contracts for the transportation of gas produced from the leased properties. The terms of any contracts made by Shell with third persons, referred to in this paragraph, were reached without review or consent of the respondents with the consequent result that Shell bears the risk inherent to those contracts.

10.

The respondents admit the allegations of Paragraph X, except that the respondents affirmatively state that any approval was a mere accommodation to Shell as a lessee. The terms and conditions of that sublease, including

[171]

the method of transportation of the gas and the method of marketing gas, were exclusively the decisions of Shell, and at Shell's risk.

11.

The respondents deny the allegations of Paragraph XI for lack of information sufficient to justify a belief.

12.

The respondents deny the allegations of Paragraph XII for lack of information sufficient to justify a belief.

13.

The respondents deny the allegations of Paragraph XIII for lack of information sufficient to justify a belief. Respondents affirmatively aver that Williams, Inc. and the other defendants are not parties to the contract described therein, that such contract was entered into without the approval or consent of Williams, Inc. or other respondents, and that the parties to that contract bear the risks of that contract.

14.

The respondents aver that Paragraph XIV states a conclusion of law and does not require an answer. Out of an abundance of caution, respondents deny the allegations of Paragraph XIV.

15.

The respondents admit the allegations of Paragraph XV.

16.

The respondents deny the allegations of Paragraph XVI for lack of information sufficient to justify a belief.

17.

The respondents deny the allegations of Paragraph XVII for lack of information sufficient to justify a belief.

18.

The respondents deny the allegations of Paragraph XVIII for lack of information sufficient to justify a belief. Respondents further aver that they were not parties to the contract described therein, did not approve or consent to

its terms, and that the contracting parties bear the risks of their agreement.

[172]

19.

The respondents deny the allegations of the first two sentences of Paragraph XIX for lack of information sufficient to justify a belief. The remainder of Paragraph XIX states a conclusion of law and does not require an answer, but out of an abundance of caution, respondents deny all of the allegations of Paragraph XIX.

20.

The first and last sentences of Paragraph XX state legal conclusions that do not require an answer, but out of an abundance of caution, respondents deny these allegations. All remaining allegations of Paragraph XX are denied for lack of information sufficient to justify a belief. Further, respondents aver that the agreements methods and contractual arrangements by which Shell and Pennzoil choose to sell, market and transport the gas produced from the leases involves an election made by Shell and Pennzoil to which the respondents are not parties. The respondents further assert that the transfer of gas from the respondents to the plaintiffs is not a transfer or sale subject to the jurisdiction of the Federal Power Commission and that the payment of royalties by the plaintiffs to the respondents for the gas produced, and the determination of the amount of the royalties, does not involve the jurisdiction of the Federal Power Commission. *Mobil Oil Company* v. *Federal Power Commission,* 463 F.2d 256, *cert. denied,* 496 U.S. 976 (1972).

21.

The respondents deny the allegations of Paragraph XXI, for lack of information sufficient to justify a belief, except

that payments from time-to-time have increased. The respondents further deny any implication that the royalty payments are governed by the Federal Power Commission rates, and aver that the payments violate the terms of the leases.

22.

The respondents deny the allegations of Paragraph XXII for lack of information sufficient to justify a belief.

23.

The respondents admit the allegations of Paragraph XXIII.

[173]

24.

The respondents admit the allegations of Paragraph XXIV, except that the respondents aver that the 60-day period has expired and the respondents have been informed by certified letter of June 5, 1974 that the leases are now cancelled.

25.

The respondents admit the allegations of the first two sentences of Paragraph XXV, and the schedule of prices per MCF, but deny all other allegations of Paragraph XXV.

26.

The respondents deny the allegations of the first sentence of Paragraph XXVI for lack of information sufficient to justify a belief. The defendants deny all other allegations of Paragraph XXVI.

27.

The respondents admit that Williams, Inc. accommodated its lessee Shell by consenting on behalf of itself and its royalty distributees to the sublease to Union and that the

then royalty distributees were aware of the approval. All other allegations of Paragraph XXVII are denied. The respondents further aver that the election to sell and transport the gas in the interstate market was the sole decision of the plaintiffs, with the consequence that the plaintiffs assumed the business risks incident to the gas sales contracts.

28.

The first two sentences of Paragraph XXVIII state legal conclusions that require no answer, but out of an abundance of caution, respondents deny such allegations. The respondents deny the allegations in the last sentence of Paragraph XXVIII for lack of information sufficient to justify a belief.

29.

The respondents deny the allegations of the first sentence of Paragraph XXIX for lack of information sufficient to justify a belief and deny the allegations of the last sentence of Paragraph XXIX.

30.

Paragraph XXX of plaintiff's petition does not contain allegations of facts, but merely states plaintiff's conclusion with respect to a hypothe-

[174]

tical factual situation, and does not require an answer. Out of an abundance of caution, respondents deny the allegations of Paragraph XXX.

31.

The respondents deny the allegations in the first sentence of Paragraph XXXI for lack of information sufficient to justify a belief and deny the last sentence of Paragraph XXXI.

32.

The respondents deny the allegations of Paragraph XXXII.

33.

The respondents admit that the plaintiffs should remit to the respondents the difference between the amounts presently being paid and the "market price" and "market rate," should the Court conclude that plaintiff have incorrectly interpreted those phrases. The respondents deny that remission of these additional royalty funds in compliance with a final judgment of this Court should entitle the plaintiffs to maintain the leases in force and effect. The respondents aver that the plaintiffs are not entitled to have the leases maintained in full force and effect, that the plaintiffs have breached the leases, that the respondents have properly cancelled the leases, and that the respondents are entitled to a judgment of this Court that the leases are no longer in effect.

34.

The respondents deny the allegations of Paragraph XXXIV.

35.

The respondents deny the allegations of Paragraph XXXV.

36.

The respondents deny the allegations of Paragraph XXXVI, except that respondents admit that respondent Williams, Inc. has declared the leases cancelled in accordance with the terms of the leases, but that respondents have abided by the Temporary Restraining Order and Preliminary Injunction heretofore issued by this Court by not interfering with the production, management and possession of the Gibson Field.

[175]

37.

The respondents deny the allegations of Paragraph XXXVII.

And now by way of defense, the respondents further affirmatively answer:

38.

The obligations owed by the plaintiffs to the respondents under the leases are governed solely by the leases which call for payment of gas royalties at "market price" or "market rate". The respondents are not being paid royalties at "market price" or market rate." The respondents are not bound by any contracts to which they are not parties and bear no risks of those agreements.

39.

The respondents aver that United Gas Pipe Line Company was, until April of 1974, a wholly-owned subsidiary of Pennzoil and therefore Pennzoil's agreement to sell gas produced from Gibson Field under the leases to United Gas Pipe Line Company does not represent an agreement or contract negotiated at arms length because of the corporate relationship of the parties. Respondents specifically deny that the agreement constitutes a transaction of any probative value in determining "market price" or "market rate".

40.

The Federal Power Commission has no jurisdiction or authority over the royalties paid to the respondents under the leases, nor has the Federal Power Commission ever set a rate for royalties to be paid under the leases. *Mobil Oil Corporation* v. *Federal Power Commission,* 463 F.2d 256, *cert. denied,* 496 U.S. 976 (1972).

41.

If payment of royalties at "market price" or "market rate", in compliance with the lease terms, increases the expenses to be borne by the plaintiffs, they have a readily available remedy in the form of formal agency procedures for seeking an adjustment in the area rate. *Placid Oil Company* v. *Federal Power Commission,* 483 F.2d 880-911 (5th Cir. 1973).

WHEREFORE, the defendants pray that the demand of the plaintiffs be rejected and that the plaintiffs be ordered to pay all costs of this suit.

[176]

AND NOW, as reconvenor, assuming the position of plaintiff-in-reconvention, the respondents show to the Court:

42.

By Mineral Lease dated August 29, 1934, F. B. Williams Cypress Company, Ltd. and C. S. Williams, Trustee, as lessors, granted Shell Petroleum Corporation, as lessee, a lease covering 61,442 acres of lessor's land situated in the Parishes of Iberville, Assumption, Iberia, St. Martin and Terrebonne ("the 1934 Williams Lease") for a five year primary term to commence with a selection date set forth therein. In accordance with the 1934 Williams Lease and subsequent agreements between lessors and lessee, Shell selected 3,508.81 acres owned by F. B. Williams Cypress Company, Ltd. in Terrebonne Parish, known as Area "K", which forms a portion of the present oil and gas field known as the Gibson Field. Subsequent releases of acreage by the lessee has reduced the total Williams, Inc. acreage in Gibson Field held under lease to Shell until June 5, 1974, to 1,864.71 acres. Lands of lessor C. S. Williams, Trustee, included under the lease did not form part of Area "K" in

Terrebonne Parish and are therefore not involved in this action.

43.

An oil well designated as the Shell Pelican No. 2 was completed as a producer on the leased premises in Area "K", and the 1934 Williams Lease was maintained in effect beyond its primary term by production until recently, when the lease was cancelled by the lessor as hereinafter set forth.

44.

By instrument dated October 13, 1934, F. B. Williams Cypress Company, Ltd. and Williams, Inc., a Louisiana corporation, entered into a joint agreement of consolidation which resulted in the creation of a new corporation under the laws of the State of Louisiana, namely, Williams, Inc., which thereupon became vested with title to the 1934 Williams Lease. By Act of Sale executed on February 21, 1935 before Lawrence K. Benson, Notary Public, Williams, Inc. (the Louisiana corporation) sold to Williams, Inc., a Delaware corporation, one of the defendants herein, all of the lands owned by the Louisiana corporation, thus transferring the land in Terrebonne Parish effected by the 1934 Williams Lease to Williams, Inc., the Delaware corporation.

• • • •

[178]

48.

By sublease dated December 29, 1942, effective as of December 24, 1941, Shell subleased to Union Producing Company its rights in the gas and certain other liquid hydrocarbons produced and to be produced under the 1934 Williams Lease and other leases by different lessors in the Gibson Field. Under the terms of the lease, the lessor must approve any assignment or sublease. As an accommodation to Shell, Williams, Inc., as lessor, formally approved the sublease to Union Producing Company.

49.

By Oil, Gas and Mineral Lease dated July 24, 1952, Williams, Inc., as lessor, leased to Mrs. Delphine C. Williams, Frank B. Williams, Elizabeth Williams Zorthian, Mrs. Leila Moore Williams, L. Kemper Williams, Mrs. Katharine Williams Tremaine, Laurence M. Williams and Mrs. Lucille Williams Mayfield, as lessees, a 20-acre tract situated in Section 36, T17S, R15E, Terrebonne Parish ("the 1952 Williams Lease"), which land is located within the Gibson Field. The named lessees assigned the 1952 Williams Lease to Shell Oil Company by assignment dated January 4, 1955. The lease was amended by Williams, Inc. and Shell by instrument dated January 24, 1955, which amendment increased the royalty stipulated under the lease from an undivided one-sixth interest to an undivided one-fourth interest.

[179]

50.

On information sufficient to justify a belief, the respondents aver that Shell Oil Company ("Shell") is the successor to Shell Petroleum Corporation, the original lessee, and that Pennzoil Producing Company ("Pennzoil") is the successor to Union Producing Company, the sublessee of gas rights under the 1934 Williams Lease, and that Shell and Pennzoil are obligated to Williams, Inc., as lessee and partial royalty owner, and the other respondents, as royalty owners under the 1934 Williams Lease, to the same extent as their predecessors, Shell Petroleum Corporation and Union Producing Company, respectively.

51.

Paragraph 4 of the 1934 Williams Lease provides in part that:

"Lessee agrees as to royalties: . . . to pay Lessor for gas and/or casinghead gas produced and saved by Lessee from the land hereby leased, (a) one-eighth ($1/8$) of the value thereof, calculated at the market rate prevailing at the well, for all such gas and/or casinghead gas used or sold for the manufacturer of gasoline, naptha, or any related product, for the operating of a sulphur plant, and (b) one-eighth ($1/8$) of the value thereof, calculated at the market rate prevailing at the well, for all such gas and/or casinghead gas used or sold off said land for purposes other than the manufacture of said products. . . ."

52.

Paragraph 3 of the 1952 Williams Lease, as amended, contains an identical royalty clause as quoted in the preceding paragraph except the percentage of royalty is "one-fourth" rather than "one-eighth."

53.

During the latter part of 1972 Williams, Inc. realized that gas royalties being paid to the respondents by Pennzoil and Shell were far below the actual market value of the gas, based on comparable gas sales in the area. By letters to Shell and Pennzoil, each dated February 7, 1973 (copies of which are attached hereto as Exhibits "A" and "B"), Williams, Inc. asserted the discrepancy in price and requested advice as to the intention of the parties to adjust royalty payments to reflect actual market value of gas. Responses from the plaintiffs indicated that the respondents were being paid royalties on the basis of a percentage of the proceeds received by the plaintiffs pursuant to sales of all gas produced to United Gas Pipe Line Co. (the

[180]

wholly-owned subsidiary of Pennzoil), rather than on the basis of the market value of the gas, as provided in the leases.

54.

By certified letters to Shell and to Pennzoil Producing Company and Pennzoil Company dated June 7, 1973 (copies of which are attached hereto as Exhibits "C" and "D"), Williams, Inc. made demand upon the addressees to comply with the obligations of the lessee under the 1934 Williams Lease by paying on all past royalties the amount by which the market value of the gas produced exceeded the amount actually paid to the royalty owners.

55.

Thereafter, representatives of Williams, Inc. and the plaintiffs conferred with respect to the demands of Williams, Inc. During these negotiations, Williams, Inc. suspended the formal demand against the plaintiffs made in its letters of June 7, 1973.

56

Because of the plaintiffs' continued refusal to pay the respondents the market value of gas produced under the leases in accordance with the terms of the leases, Williams, Inc. on behalf of itself as lessor and royalty owner under both the 1934 Williams Lease and the 1952 Williams Lease, and on behalf of all of the royalty owners named in paragraph 47 above under the 1934 Williams Lease, made formal demand by certified letter dated March 27, 1974 addressed to Shell, Pennzoil Company and Pennzoil Producing Company, for compliance with the obligations under both leases to pay lessor and its assigns the gas royalty calculated on the basis of the market rate prevailing at the well. The certified letter also stated the amounts that

Williams, Inc. considered owing through December 31, 1973 because of the plaintiffs' failure to pay royalties in accordance with the leases and stated the basis for such calculation. The letter further demanded cancellation and termination of the leases in view of the failure of the lessee and its related parties to comply with the obligations under the leases with respect to payment of proper royalties. A copy of the certified letter of March 27, 1974 is attached hereto as Exhibit "E".

[181]

57.

Despite the aforesaid demands, Shell and Pennzoil failed to remedy their default under the leases. By certified letter to Shell and Pennzoil dated June 5, 1974 (a copy of which is attached hereto as Exhibit "F"), Williams, Inc. declared the 1934 Williams Lease and the 1952 Williams Lease to be terminated because of the failure of Shell and Pennzoil to pay proper royalty in accordance with the terms of the leases.

58.

From October 1, 1971 through May 31, 1974 (the most recent accounting date prior to the date of termination), the plaintiffs underpaid royalties to respondents on gas produced from Gibson Field in the aggregate amount of $1,544,771.39, of which Pennzoil underpaid $1,055,204.62 and Shell underpaid $489,566.77. These amounts represent the difference between the royalties actually paid and the royalties that should have been paid by the plaintiffs based on the value of gas, calculated at the market price prevailing at the well in accordance with the terms of the leases, using the following market rates which respondents believe prevailed in the area during the period from October 1, 1971 through May 31, 1974:

Period	Price of Gas Per Thousand Cubic Feet (MCF)
October 1, 1971 — March 2, 1973	$ .35
March 3, 1973 — September 30, 1973	$ .45
October 1, 1973 — November 8, 1973	$ .54
November 9, 1973 — May 31, 1974	$ .70

59.

The plaintiffs' failure to pay royalties in accordance with the terms of the 1934 Williams Lease and the 1952 Williams Lease is sufficient grounds for cancellation and termination of the leases. The respondents have complied with all conditions imposed under the leases for cancelling the leases by giving the plaintiffs 60-day written notice of plaintiffs' default under the leases and stating the facts upon which respondents' demand was based.

[182]

60.

Defendants' failure to comply with the plaintiffs' demand within the 60-day period following the date of demand entitled Williams, Inc. to cancel the leases, as it did in its letter to the plaintiffs dated June 5, 1974.

61.

By virtue of the cancellation of the leases by Williams, Inc., the leases are no longer in force and effect. Accordingly, Williams, Inc. as owner of the land is entitled to be paid the value of 100 percent of all oil, gas and other hydrocarbons and minerals extracted and removed from its lands previously covered by the 1934 Williams Lease and the 1952 Williams Lease, and the plaintiffs are obligated to account to Williams, Inc. for the value of the production since cancellation of the leases on June 5, 1974.

62.

In addition to the foregoing, the plaintiffs are liable unto Williams, Inc. for reasonable attorneys' fees incurred in bringing this suit to have the cancellation adjudged and for all damages suffered by Williams, Inc. by reason of its inability to contract in regard to the mineral rights because of the plaintiffs' failure to acknowledge the cancellation. La. R.S. 30:101-102.

63.

Respondents reserve their rights to amend this reconventional demand to allege additional amounts owed as royalties if further investigation reveals that the market rate of gas exceeds the rates alleged in paragraph 58 hereof.

WHEREFORE, respondents pray that there be judgment herein in favor of the respondents and plaintiffs-in-reconvention and against the plaintiffs and defendants-in-reconvention as follows:

1. With respect to plaintiffs' demand for declaratory judgment, declaring that plaintiffs' interpretation of the phrases "market rate" and "market price" in the leases is erroneous and that the respondents' interpretation of these phrases is correct, that the plaintiffs have failed to discharge their royalty obligations to the respondents in accordance

[183]

with the subject leases and that the subject leases are no longer in force and effect.

With respect to respondents' reconventional demand:

2. Decreeing that the 1934 Williams Lease and the 1952 Williams Lease were cancelled and terminated as of June 5, 1974, and ordering the plaintiffs to relinquish possession of the leased premises to Williams, Inc.

3. Awarding Williams, Inc. reasonable attorneys' fees incurred in bringing this suit to have the cancellation of the leases adjudged in this proceeding.

4. Awarding Williams, Inc. damages suffered by it by reason of its inability to contract in regard to the mineral rights because of the failure of the plaintiffs to acknowledge the cancellation.

5. Ordering Pennzoil to pay the respondents damages in the amount of $1,055,204.62 and Shell to pay respondents damages in the amount of $489,566.77 for underpaid royalties through May 31, 1974, and ordering the plaintiffs to account to the defendants and pay in damages the difference between the market value of royalty gas collected and sold by the plaintiffs from June 1 through June 5, 1974, such award of damages to be divided among the respondents in accordance with their percentage ownership of royalties set forth in paragraph 48 of respondents' reconventional demand.

6. Ordering the plaintiffs to account to Williams, Inc. for the value of all oil, gas and other hydrocarbons and minerals extracted after June 5, 1974 from the lands heretofore leased to the plaintiffs under the leases, and after the accounting is made, ordering the plaintiffs to pay such amounts to Williams, Inc. as damages.

7. Ordering the plaintiffs to pay legal interest on the amounts due to the respondents from the date of judicial demand until paid, and to pay all costs of this proceeding.

[184]

8. Granting respondents all general and equitable relief to which they may be entitled.

. . . .

Campbell C. Hutchinson

. . . .

Anthony M. DiLeo
Of
STONE, PIGMAN, WALTHER,
WITTMANN & HUTCHINSON
1000 Whitney Bank Building
New Orleans, Louisiana
70130
Telephone: 581-3200

Attorneys for Respondents and Plaintiffs-In-Reconvention

• • • •

[185]

EXHIBIT 6 (ADG-6)
CIVIL DISTRICT COURT
FOR THE
PARISH OF ORLEANS
STATE OF LOUISIANA

NO. 573-581 DIVISION "A" DOCKET 5

SHELL OIL COMPANY
AND
PENNZOIL PRODUCING COMPANY
VS.
WILLIAMS, INC., *et al*

FILED: June 27, 1975

Deputy Clerk

SUPPLEMENTAL AND AMENDING
RECONVENTIONAL DEMAND

Now into Court, through undersigned counsel, come Williams, Inc. and Frank B. Williams individually and as Executor of the Succession of Mrs. Delphine C. Williams, Laurence M. Williams, The Kemper and Leila Williams Foundation, Lucille W. Mayfield Trusts for Ann Marsak and for Alec Andrew Johnson, Ann Marsak, Alec Andrew Johnson, Mrs. Katherine W. Tremaine, Elizabeth Williams, Trust, Elizabeth Williams, Mrs. Elizabeth Campbell Brooks, Whitney L. Brooks, Trustee for Anne Campbell, Alan Adams Campbell, and Valley Bank & Trust Company, Executor u/w Holbrook Campbell, defendants and plaintiffs-in-reconvention ("respondents") in the above-numbered and entitled proceeding, who supplement and amend their original reconventional demand filed herein on

July 17, 1974, with the written consent of counsel for the plaintiffs, in the following respects:

I. By adding an additional paragraph following paragraph 58 of the Reconventional Demand as follows:

58(a).

From June 1, 1974 through April 30, 1975 (the most recent month for which royalties have been paid), the plaintiffs underpaid royalties to respondents on gas produced from Gibson Field in the aggregate amount of $2,186,912.40, of which Pennzoil underpaid $1,989,-222.91 and Shell underpaid $197,689.49. These amounts represent the difference between the royalties actually paid and the royalties that should have been paid by the plaintiffs based on the value of gas, calculated at the market price prevailing at the well in accordance with the terms of the leases, using

[186]

the following market rates which respondents believe prevailed in the area during the period from June 1, 1974 through April 30, 1975:

Period	Price of Gas Per Mcf
June 1, 1974-December 31, 1974	$1.30
January 1, 1975-April 30, 1975	$1.40

II. By adding an additional paragraph to respondents' original prayer following paragraph 6 of the prayer to read as follows:

6(a) In the alternative, if this Court holds that the 1934 Williams lease and the 1952 Williams lease were not cancelled and terminated as of June 5, 1974, ordering Pennzoil to pay respondents damages in the amount of $3,044,427.53 and Shell to pay respondents damages in the amount of $597,256.26 for underpaid royalties through April 30, 1975, and additional damages equal to the excess of the market value of royalty gas over the amounts actually paid to the respondents as gas royalties for the period from May 1, 1975 to the date of judgment, such award to be divided among the respondents in accordance with their percentage ownership of royalties set forth in paragraph 48 of respondents' reconventional demand.

WHEREFORE, respondents, reiterating the prayer of their original Reconventional Demand, as supplemented and amended herein, pray that this supplemental and amending reconventional demand be filed, and that after due proceedings, there be judgment herein in favor of the respondents, in accordance with the original prayer, as supplemented and amended herein.

Campbell C. Hutchinson
Of
Stone, Pigman, Walther,
Wittmann & Hutchinson
1000 Whitney Bank Building
New Orleans, Louisiana
70130
Telephone: 581-3200

Attorneys for Respondents
and
Plaintiffs-in-Reconvention

• • • •

[187]

June 18, 1975

United Gas Pipe Line Company
P. O. Box
Houston, Texas 77001

Gentlemen:

Please refer to that certain gas purchase contract effective November 1, 1959, as heretofore amended ("Contract"), by and between United Gas Pipe Line Company, as Buyer, and Union Producing Company (predecessor to Pennzoil Producing Company), as Seller, under the terms of which Buyer is purchasing from Seller merchantable natural gas produced from certain lands and leaseholds located in Gibson Field, Terrebonne Parish, Louisiana. Seller has advised, as a result of litigation pending in *Shell Oil Company and Pennzoil Producing Company* v. *Williams, Inc., et al.,* Docket No. 573-591 (Civil District Court for the Parish of Orleans, State of Louisiana), that Seller may be required to make royalty payments to its lessors at a rate in excess of the rate heretofore paid as royalty or that in the absence of such greater royalty payments certain lessors have threatened to terminate some of the underlying leases. Seller has also advised that it is likely that other royalty owners in the Gibson Field will make similar demands. Seller has also advised that pursuant to a Settlement Agreement between Seller and certain of Seller's lessors, a copy of which is attached hereto as Exhibit A, payment of increased royalties or release of one-eighth of the gas back to such lessors may be required or permitted by the Federal Power Commission. In order to avoid the termination of leases, and loss of gas to Seller and Buyer, Seller has requested that Buyer reimburse Seller for such excess payment for each of its lessors in the Gibson Field or, in the alternative, release the royalty portion of the gas from the terms of the Contract. Buyer is agreeable to such arrangement on the following terms; accordingly, the parties hereto do hereby agree as follows:

[188]

1.

In the event Seller receives authorization from the Federal Power Commission to collect from Buyer increased sums payable to Seller's lessors as royalty on gas delivered after January 1, 1974, under the Contract, Buyer shall, beginning on the date Seller is authorized to collect such amounts, pay to Seller such sums covering the periods authorized by the Federal Power Commission. Any payments authorized by the Federal Power Commission for royalty gas delivered after January 1, 1974 through the date of the FPC's final order shall be amortized over a period of one year from the date of the FPC's final order. In the event of the cessation of Federal Power Commission regulation of producer gas sales as described in Exhibit A hereto, Buyer shall at all times pay to Seller the sums necessary to permit Seller to pay each of its lessors in the Gibson Field who have the right to receive a royalty on gas sold from such field by Seller to Buyer (regardless of whether such lessor is a party to the attached Exhibit A) the royalties specified in Exhibit A hereto; such payments shall be made from time to time as necessary to permit Seller to remit such sums to its lessors in a timely fashion and without regard to any other provision of the November 1, 1959 Contract, except as amended hereby.

This Section 1 of this amendatory agreement shall automatically become void and of no force or effect on the date the Settlement Agreement attached hereto as Exhibit A is terminated pursuant to the terms thereof.

2.

In the event Seller receives authorization from the Federal Power Commission to abandon or release to its lessors one-eighth ($1/8$) of such gas, Buyer will amend the Contract in such manner as to effect the release of such one-eighth ($1/8$) of such gas from the terms and provisions of the Contract; provided that Buyer will have no obligation under Sections 1 and 2 hereof unless and until either of the alternative authorizations is granted by final order of the Federal Power Commission as contemplated hereby.

3.

By its execution hereof Buyer does not become a party to, an obligor or guarantor under, beneficiary of or bound in any way by the Settlement Agreement attached hereto as Exhibit A.

[189]

4.

This agreement shall become effective as of the date first hereinabove written.

5.

This agreement is subject to all present and future orders, rules and regulations of any governmental or regulatory body having jurisdiction.

If the foregoing is in accordance with your understanding of the agreement between us, please so signify by executing the duplicate originals hereof in the space provided below and returning one of such originals to us. On our execution hereof, this agreement shall constitute an amendment to the

Contract and shall be binding upon us and upon our respective successors and assigns.

Very truly yours,

Pennzoil Producing Company

By James T. Goodwyn

ACCEPTED AND AGREED TO:

United Gas Pipeline Company

By D. Lamar Smith

[190]

June 23, 1975

United Gas Pipe Line Company
P. O. Box 1478
Houston, Texas 77001

Gentlemen:

Please refer to that certain gas purchase contract effective May 1, 1959, as heretofore amended ("Contract") by and between United Gas Pipe Line Company, as buyer, and Shell Oil Company, as Seller, under the terms of which Buyer is purchasing from Seller merchantable natural gas produced from certain lands and leaseholds located in Gibson Field, Terrebonne Parish, Louisiana. Seller has advised, as a result of litigation pending in *Shell Oil Company and Pennzoil Producing Company* v. *Williams, Inc., et al.*, Docket No. 573-591 (Civil District Court for the Parish of Orleans, State of Louisiana), that Seller may be required to make royalty payments to its lessors at a rate in excess of the rate heretofore paid as royalty or that in the absence of such greater royalty payments certain lessors have threatened to terminate some of the underlying leases. Seller has also advised that it is likely that other royalty owners in the Gibson Field will make similar demands. Seller has also advised that pursuant to a Settlement Agreement between Seller and certain of Seller's lessors, a copy of which is attached hereto as Exhibit A, payment of increased royalties or release of one-eighth of the gas back to such lessors may be required or permitted by the Federal Power Commission. In order to avoid the termination of leases and loss of gas to Seller and Buyer, Seller has requested that Buyer reimburse Seller for such excess payment for each of its lessors in the Gibson Field or, in the alternative, release the royalty portion of the gas from the terms of the Contract. Buyer is agreeable to such arrangement on the following terms; accordingly, the parties hereto do hereby agree as follows:

1.

In the event Seller receives authorization from the Federal Power Commission to collect from Buyer increased sums payable to Sellor's lessors as royalty on gas delivered after January 1, 1974, under the Contract, Buyer shall, beginning on the date Seller is authorized to collect such amounts, pay to

[191]

Seller such sums covering the periods authorized by the Federal Power Commission. Any payments authorized by the Federal Power Commission for royalty gas delivered after January 1, 1974, through the date of the Federal Power Commission's final order, shall be amortized over a period of one year from the date of the Federal Power Commission's final order. In the event of the cessation of Federal Power Commission regulation of producer gas sales as described in Exhibit A hereto, Buyer shall at all times pay to Seller the sums necessary to permit Seller to pay each of its lessors in the Gibson Field who have the right to receive a royalty on gas sold from such field by Seller to Buyer (regardless of whether such lessor is a party to the attached Exhibit A) the royalties specified in Exhibit A hereto; such payments shall be made from time to time as necessary to permit Seller to remit such sums to its lessors in a timely fashion and without regard to any other provision of the (May 1, 1959) Contract, except as amended hereby.

This Section 1 of this amendatory agreement shall automatically become void and of no force or effect on the date the Settlement Agreement attached hereto as Exhibit A is terminated pursuant to the terms thereof.

2.

In the event Seller receives authorization from the Fed-

eral Power Commission to abandon or release to its lessors one-eighth (1/8) of such gas, Buyer will amend the Contract in such manner as to effect the release of such one-eighth (1/8) of such gas from the terms and provisions of the Contract; provided that Buyer will have no obligation under Sections 1 and 2 hereof unless and until either of the alternative authorizations is granted by final order of the Federal Power Commission as contemplated hereby.

3.

By its execution hereof Buyer does not become a party to, an obligor or guarantor under, beneficiary of or bound in any way by the Settlement Agreement attached hereto as Exhibit A.

4.

This agreement shall become effective as of the date first hereinabove written.

5.

This agreement is subject to all present and future orders, rules and regulations of any governmental or regulatory body having jurisdiction.

[192]

If the foregoing is in accordance with your understanding of the agreement between us, please so signify by executing the duplicate originals hereof in the space provided below and returning one of such originals to us. On our execution hereof, this agreement shall constitute an amend-

ment to the Contract and shall be binding upon us and upon our respective successors and assigns.

Very truly yours,

Shell Oil Company

By S. M. Paine
General Manager
Production

ACCEPTED AND
AGREED TO:

United Gas Pipeline
Company

By D. Lamar Smith

[194]

MINERAL LEASE

KNOW ALL MEN BY THESE PRESENTS:

1. That *F. B. WILLIAMS CYPRESS COMPANY, LIMITED,* herein appearing and represented by its Vice-President, *C. S. WILLIAMS,* duly authorized, and *C. S. WILLIAMS,* Trustee, herein called *LESSOR* (whether one or more), for and in consideration of TEN THOUSAND AND NO/100 ($10,000.00) DOLLARS, the receipt of which, as a full and adequate consideration for every right granted herein, is hereby acknowledged, does hereby grant, demise and lease unto *SHELL PETROLEUM CORPORATION,* herein called *LESSEE,* for the purpose, and with the exclusive right, of exploring, prospecting, drilling, mining and operating for, and of producing and taking, oil, gas, casinghead gas, sulphur and all other minerals thereon and therefrom; of saving, storing, taking care of, treating, manufacturing, loading and transporting such substance thereon and therefrom; and of constructing, maintaining, using, enjoying and, at any time during or after the term hereof, removing any machinery, plants, stations, casing, pipes, pipe lines, tanks, bins, reservoirs, storage accommodations, camps, houses, or buildings, any telephone, telegraph, light or power cables or lines, any rail or other roads or ways, and, in general, any appliances, structures, equipment, easement, servitudes, and privileges which may be necessary, useful or convenient to or in connection with any such operations conducted by Lessee thereon, or on any adjacent lands, all that certain land lying in the Parishes of Iberville, Assumption, Iberia, St. Martin and Terrebonne, the said lands being more specificially described on a certain exhibit hereto attached, which has been initiated by the parties and marked Exhibit "A".

It is understood that C. S. WILLIAMS, Trustee, holds title to the following lands:

> "That certain tract of land situated in the Parish of Assumption, State of Louisiana, described as the Northeast Quarter and Lot 4 of Section 13, T. 14 S., R. 13 East, and Section 39 and the Northwest Quarter of Section 38, T. 14 S. R. 14 East, containing approximately 1030 acres, including such rights as the vender may have in a certain drainage canal forming part of the drainage
>
> [195]
>
> system of Drainage District No. 1 of Assumption Parish, generally referred to as the CAHCIRENE CANAL, together with all rights, ways, privileges, appurtenances, prescriptions and possessory rights, all batture and batture rights, and all other rights of a riparious nature, and all buildings and improvements on said property."

But for the purposes of this lease, all of the lands herein described shall be treated as a whole and as one unit as though held under one ownership.

2. For the purposes of determining the amount of money payment hereunder, said leased lands shall be considered to comprise sixty-one thousand four hundred forty-two (61,442) acres even though they actually comprise more or less, but it is Lessor's intention to lease and Lessor does hereby lease, in addition to the Land above described, all of the land now owned or claimed by Lessor by limitation or otherwise and located in said Parish EXCEPT those lands situated in the Parishes of Iberia and St. Martin, State of Louisiana, described as follows:

> East Half (E½) of Section 33; West Half (W½) of Section 34, West Half (W½) of Southeast Quarter (SE¼) of Section 34; Township 12 South, Range 11 East;

East Half (E½) of Section 4; West Half (W½) and Southwest Quarter (SW¼) of Northeast Quarter (NE ¼) and the Southwest Quarter (SW¼) of the Southeast Quarter (SE¼) of Section 3;

Township 13 South, Range 11 East, comprising 1440 acres.

Lessor expressly agrees to deliver to Lessee any supplemental instrument deemed necessary or required by Lessee for a more complete and accurate description of the lands thus intended to be leased.

3. This lease shall remain in force as to all minerals, and for all purposes covered thereby, for a primary term extending from the date hereof to, and to include five (5) years from and after the selection date fixed by Section 5 hereof, and as long after such primary term as, either (1) oil, gas, casinghead gas, sulphur, or any other mineral is produced by Lessee from the land hereby leased; or, (2) drilling or mining operations upon said land are being prosecuted by Leasee with reasonable diligence, and, in the absence of production, not more than ninety (90) days shall elapse between the completion or abandonment of one well or mine and the commencement of operations for the drilling or excavating of another.

[196]

4. Lessee agrees as to royalties: First, to deliver to the credit of Lessor, free of expense in the pipe line to which Lessee may connect Lessee's wells the equal one-eighth (⅛) part of all oil produced and saved by Lessee from the land hereby Leased, or, from time to time, to pay Lessor the posted market price of such one-eighth (⅛) part of such oil as of the day it is run to the pipe line or storage tanks, Lessor's interest, in either case, to bear its proportion of any expenses of treating unmerchantable oil to render it merchantable as crude; provided that from time to time,

upon demand from Lessor so to do, Lessee shall be obligated to take said royalty oil and pay Lessor therefor the posted market price as above provided; Second, to pay Lessor for gas and/or casinghead gas produced and saved by Lessee from the land hereby leased, (a) one-eighth (⅛) of the value thereof, calculated at the market price prevailing at the well, for all such gas and/or casinghead gas used or sold for the manufacture of gasoline, naptha, or any related product, or for the operating of a sulphur plant, and (b) one-eighth (⅛) of the value thereof, calculated at the market rate prevailing at the well, for all such gas and/or casinghead gas used or sold off said land for purposes other than the manufacture of said products; Third, to pay Lessor One ($1.00) Dollar per long ton (2240 pounds) for all sulphur produced from the land hereby leased; Fourth, to pay Lessor what, under all the circumstances, shall be a reasonable money royalty for any other mineral produced and marketed by Lessee from said land.

* * * *

[206]

September 26, 1975

The Honorable Samuel Z. Gordon
Administrative Law Judge
Federal Power Commission
825 North Capitol Street N.E.
Washington, D. C. 20426

In re: Pennzoil Producing Company
Docket No. RI76-8
Shell Oil Company
Docket No. RI76-10

Dear Sir:

At transcript page 83 and following, your Honor agreed to permit Shell to ask Mr. John F. Bruskotter certain questions dealing with revenues, volumes, taxes, and royalty costs, and permit him to supply this information for the record by mail. I am therefore enclosing the additional testimony of Mr. Bruskotter supplying this data. A copy of this data is also being supplied to Staff Counsel by courier. Copies have been mailed to the other parties to the proceedings.

Respectfully submitted,

THOMAS G. JOHNSON
Thomas G. Johnson

[207]

ADDITIONAL PREPARED TESTIMONY OF JOHN F. BRUSKOTTER IN SHELL OIL COMPANY DOCKET NO. RI76-10

Q. At transcript page 83 and following, I asked you for a breakdown of the revenue received by Shell for the 1934 lease and the 1952 lease by lease, by price, and by volume. Would you give that to us now, please?

A. There are four prices being received by Shell from these leases, instead of the two prices stated in my earlier testimony. These prices and the volumes for the period from April 1, 1974 to April 1, 1975 are as follows:

	Price (¢ per Mcf)	Volume (MMcf)
1934 lease:	30.1125	583.3
	31.1125	245.4
	58.8595	139.1
	59.8855	62.6
		1030.4 Total

	Price (¢ per Mcf)	Volume (MMcf)
1952 lease:	30.1125	135.2
	31.1125	45.5
	58.8595	67.4
	59.8855	30.9
		279.0 Total

Q. On what pressure base are these prices calculated?

A. 15.025 psia.

Q. Why have you utilized the period April 1, 1974 to April 1, 1975?

A. I suggested the July 1975 figure as a benchmark because it was the most recent figure available. Upon further

study, it became apparent that on a monthly basis the variation in volumes would cause the unit price figure to be erratic. Therefore, I believe the annual figure is more representative of the volume price relationship. We used the period of April 1, 1974 to April 1, 1975 to be consistent with the time period used by Mr. Gray in his testimony.

Q. At transcript page 84, I asked you for the average price per Mcf of gas delivered or attributed to the 1934 lease for the month of July 1975. Would you now answer that question?

A. The average price attributed to Shell's interest in the 1934 lease for the period from April 1, 1974 to April 1, 1975 was 39.0¢ per Mcf.

[208]

Q. What would the average price per Mcf be for the 1952 lease for the period from April 1, 1974 to April 1, 1975?

A. The average price per Mcf for the 1952 lease for this period was 41.6¢ per Mcf.

Q. At page 84, I asked you for the price per Mcf for each of the two leases if the additional royalty provided for in the settlement, based on a 78¢ per Mcf price, were permitted to be "flowed through" by the Commission?

A. For the 1934 lease, the price per Mcf would be 42.6¢ Mcf, and for the 1952 lease the price would be 50.6¢ Mcf.

Q. At page 88, I asked you to calculate the revenue remaining to Shell on each lease after deducting the additional royalty claimed by Williams Inc., the severance taxes due the State of Louisiana, and the operating costs testified to by you of 4.5¢. Would you do that now, please?

A. For the 1934 lease, the average revenue was 39.0. The royalty on this lease, based on the $1.40 per Mcf market

value claimed by Williams, would be 17.5¢. The Louisiana severance tax paid by Shell is 6.125¢. The operating cost was 4.5¢. Therefore, the net revenue to Shell on the 1934 lease would be 10.875¢ per Mcf. This would not include amortization of capital invested, return on investment, or federal income taxes.

Q. What is the revenue remaining to Shell on the 1952 lease, based on the same assumptions?

A. The revenue to Shell on the 1952 lease was 41.6¢ per Mcf. The royalty on this lease, based on the $1.40 per Mcf market value claimed by Williams, would be 35¢. The Louisiana severance tax paid by Shell would be 5.25¢. The operating costs of 4.5¢ are deducted. Therefore, the net loss to Shell on the 1952 lease would be 3.15¢ per Mcf.

Q. At page 90, the Staff requested that you supply a copy of the 1952 lease, identified as Exhibit No. 10 and received into evidence at page 91. Do you have that lease?

A. Yes. It is attached to this testimony.

Q. At transcript pages 103 and following, Staff counsel asked for a further breakdown of the 4.5¢ operating costs attributable to these leases. Are you able to provide such a breakdown?

[209]

A. The major categories are: (1) direct lease expense; (2) overhead charges; (3) property taxes and insurance; (4) reconditioning and recompletion. The breakdown into these categories is as follows:

1. Direct lease expense —	3.8¢	per Mcf
2. Overhead charges —	0.5¢	"
3. Property taxes and insurance —	0.2¢	"

The reconditioning and recompletion costs are included in direct lease expense.

Q. At transcript page 105, the Staff asked for a further breakdown of direct lease expense. Have you been able to do this?

[210]

A. Yes. I have broken this expense down into the following categories:

Surface Expenses	
Wellhead and Flowlines	.34
Testing and Treating	.63
Compression of Gas	.44
Gas Dehy. & Dist.	.22
Waste Water Handling	.15
Office Quarters and Field Equipment	.35
Field Supervision	.27
Other	.06
Subsurface Expenses	
Major Well Work	1.04
Routine Well Work	0.30
Total	3.80

Q. Have you been able to qualify any other cost items besides operating costs within the time allowed?

A. As I previously testified, the costing units involved include not only the two base leases, but also the attributable portion of 10 separate operating units within which these leases are included. These leases and units have been developed over a time period of 38 years. There are multiple reservoirs in the field, which gives the calculation a three dimensional character. Therefore, it is not possible, even by October 3, to develop the capital investment, amortization, return, and federal income taxes attributable to these leases.

Q. Do you have any suggestion as to how these costs could be estimated?

A. In the optional procedure cases the Commission made the assumption that the nationwide costs determined in the last Commission opinion were to be used in the absence of better figures. Therefore, I have reproduced the cost summary attached as Appendix C to Opinion 699H, substituting the 4.5¢ operating cost and the increased royalty which Shell would have to pay for the corresponding figures in the Commission cost analysis. This schedule is attached hereto as Appendix A. Using the 1972 average costs, the total cost for the 1934 lease is 59.07¢ Mcf. Using the trended cost, the total cost for the 1934 lease is 62.13¢ Mcf. For the 1952 lease, the cost using 1972 average figures is 76.57¢ per Mcf. Using the trended cost method for the 1952 lease, the total cost is 79.63¢ Mcf.

Q. Does Shell plan to present any additional cost data in this proceeding?

A. For the reasons above stated, we do not.

[211]

APPENDIX A

COST COMPONENT	1972 DATA	TRENDED DATA	1972 DATA 1934 LEASE	TRENDED DATA 1934 LEASE	1972 DATA 1952 LEASE	TRENDED DATA 1952 LEASE
Successful Wells	5.68	6.15	5.68	6.15	5.68	6.15
Recompletions & Deeper Drilling	0.20	0.20	0.20	0.20	0.20	0.20
Lease Acquisition	3.83	4.28	3.83	4.28	3.83	4.28
Other Production Facilities	1.28	1.39	1.28	1.39	1.28	1.39
Subtotal	10.99	12.02	10.99	12.02	10.99	12.02
Dry Holes	3.77	3.72	3.77	3.72	3.77	3.72
Other Exploration	2.62	2.80	2.62	2.80	2.62	2.80
Exploration Overhead	0.82	0.82	0.82	0.82	0.82	0.82
Subtotal	7.21	7.34	7.21	7.34	7.21	7.34
Operating Expense	3.10	3.10	4.50	4.50	4.50	4.50
Regulatory Expense	0.20	0.20	0.20	0.20	0.20	0.20
Net Liquid Credit	(3.89)	(3.89)	(3.89)	(3.89)	(3.89)	3.89
Return on Working Capital	1.14	1.25	1.14	1.25	1.14	1.25
Return on Investment	21.42	23.21	21.42	23.21	21.42	23.21
Subtotal	40.17	43.23	*41.57	44.63	41.57	44.63
Royalty	7.65	8.23	17.50	17.50	35.00	35.00
Total	47.82	51.46	59.07	62.13	76.57	79.63

[214]

OIL, GAS AND MINERAL LEASE

THIS AGREEMENT made this 24th day of July 1952, between WILLIAMS, INC., a Delaware corporation, authorized to do business in Louisiana, having its offices in the Whitney Building, New Orleans, Louisiana (hereinafter called "Lessor"), and MRS. DELPHINE C. WILLIAMS, a resident of New Orleans, Louisiana, FRANK B. WILLIAMS, a resident of New Orleans, Louisiana, MRS. ELIZABETH WILLIAMS ZORTHIAN, a resident of Altadena, California, MRS. LEILA MOORE WILLIAMS, a resident of New Orleans, Louisiana, L. KEMPER WILLIAMS, a resident of New Orleans, Louisiana, MRS. KATHARINE WILLIAMS TREMAINE, a resident of Santa Barbara, California, LAURENCE M. WILLIAMS, a resident of New Orleans, Louisiana, and MRS. LUCILLE WILLIAMS MAYFIELD, a resident of Tyler, Texas, (hereinafter collectively called "Lessee").

WITNESSETH:

1. Lessor in consideration of FOUR THOUSAND and 00/100 ($4,000.00) DOLLARS in hand paid, of the rentals and royalties herein provided, and of the agreements of Lessee herein contained, hereby grants, leases and lets exclusively unto Lessee for the purpose of testing by any method or methods for formation or structures, investigating, exploring, prospecting, drilling and mining for and producing oil, gas and all other minerals thereon and therefrom, and, but not exclusively, building roads or ways, canals, (as to which roads or ways and canals, Lessor, its successors, assigns and licensees shall, subject to Lessee's prior rights under this lease, have the right to use at its own risk), laying pipe lines, building tanks, power stations, telephone lines and other structures thereon to produce, save, take care of, treat, transport and own

[215]

said products, and housing its employees, and at any time during, or within one hundred twenty (120) days after the expiration hereof, removing the same therefrom, the following described lands in Terrebonne Parish, Louisiana, to-wit:

> Twenty acres more or less out of Section 36, Township 17 South, Range 15 East, more particularly described as follows:
>
> Beginning at a point in the northerly boundary of said Section 36, at the most westerly corner of Section 17, said Township and Range; thence with the common line between said Sections 17 and 36 South 56° 53″ East 924′ to the most southerly corner of said Section 17, being a point at the northwesterly line of Section 16, said Township and Range; thence South 33° 7″ West at 315.4′ passing the most westerly corner of Section 16, 942.9′ to a corner; thence North 56° 53″ West 924′ to a corner; thence North 33° 7″ East at 878.3′ passing the most southerly corner of Section 18, 942.9′ to the point of beginning, containing twenty acres more or less.

For the purpose of calculating the payments hereinafter provided for, said land shall be treated as comprising 20 acres, whether it actually comprises more or less.

2. Subject to the other provisions herein contained, this lease shall remain in force as to all minerals and for all purposes covered hereby for a term (hereinafter called Primary Term) of five (5) years after the date hereof, and as long after such primary term as either (1) oil, gas, casinghead gas, condensate, sulphur or any other mineral is being produced in paying quantities by Lessee from the land hereby leased, or (2) drilling or mining operations upon said land are being prosecuted by Lessee with reasonable diligence, as hereinafter defined. Whenever in this lease there is a requirement of reasonable or due diligence,

without limiting otherwise the meaning of such requirement, such a provision shall be construed to require that (a) within ninety (90) days of the completion or discontinuance of work upon one well or mine, Lessee shall commence reworking operations or operations for the

[216]

drilling or excavation of another well or mine; (b) the reworking, drilling or excavation shall be pursued with reasonable diligence in a bona fide effort to produce oil, gas or other mineral in paying quantities. Whenever in this lease there is a requirement that operations for the drilling of a well shall be begun, such operations shall be deemed to have begun when location has been staked and road, canal or other means of access to the location has been started and such operations, when begun, shall be pursued to commence actual drilling with reasonable diligence.

3. Lessee agrees as to royalties:

First, to deliver to the credit of Lessor, free of expense in the pipe line to which Lessee may connect Lessee's wells, or at the wells into tanks or storage facilities furnished by Lessor, the equal one-sixth (1/6) part of all oil produced and saved by Lessee from the land hereby leased, or, from time to time, at Lessor's election, to pay Lessor the posted market price of such one-sixth (1/6) part of such oil as of the day it is run to the pipe line or Lessee's storage tanks, Lessor's interest in either case, to bear its proportion of any expense of treating unmerchantable oil to render it merchantable as crude; provided that until and unless Lessee is given one hundred twenty (120) days notice by Lessor that Lessor elects to take royalty oil in kind, Lessee shall be obligated to take said royalty oil with Lessee's oil and pay Lessor therefor the posted market price as above provided; should Lessor elect to receive royalty oil in kind, Lessor shall furnish and pay for facilities on the leased

premises to receive and store said oil or means of transporting the same from the leased premises as currently produced. Lessor may, from time to time, exercise its rights of election to take royalty oil in kind or to require Lessee to purchase

[217]

Lessor's royalty oil, all as above provided, by giving one hundred twenty (120) days notice to Lessee, and, without modification of the foregoing, Lessor may cancel or countermand any notice of election theretofore given at any time within ninety (90) days after giving the same. Lessee agrees that it will run said royalty oil into its receiving or measuring tank or tanks placed on said leased premises, and at regular intervals when Lessee runs its oil from said receiving or measuring tank or tanks into storage tanks or pipe line or other mode of transportation, Lessor agrees that Lessor's royalty oil at said time may be removed from said receiving or measuring tank or tanks. Should Lessor fail to have available storage or transportation facilities for its royalty oil when such oil is run from such receiving or measuring tank or tanks by Lessee, Lessee shall run and sell said royalty oil together with Lessee's portion of said oil unto Lessee's purchaser (or if the same is not being purchased, then to Lessor's credit in pipe line to which such oil may be run) notwithstanding any notice that Lessor may have given to Lessee that Lessor would take said royalty oil in kind; it being agreed that said election shall not become operative unless and until Lessor does furnish adequate receiving and storage or transportation facilities therefor:

Second, to pay Lessor for gas, condensate and/or casinghead gas produced and saved by Lessee from the land hereby leased, (a) one-sixth ($\frac{1}{6}$) of the value thereof, calculated at the market price prevailing at the well, for

all such gas, condensate and/or casinghead gas used in or sold for the manufacture of gasoline, naphtha or any related product, or for the operating of a sulphur plant, and (b) one-sixth ($\frac{1}{6}$) of the value thereof, calculated at the market price prevailing at the well, for all such gas, condensate and/or casinghead gas used or sold off said land for purposes other than the manu

[218]

facture of said product; and

Third, to pay Lessor Two and 50/100 ($2.50) Dollars per long ton (2240 pounds) for all surplur mined and marketed from the land hereby leased; and

Fourth, to pay Lessor one-sixth (1/6) of the value, calculated at the market value prevailing at the well or mine, of all other minerals mined and marketed by Lessee from said land.

4. This lease shall terminate one (1) year after the date hereof, unless Lessee, on or prior to that date (hereinafter called "rental date"), either (a) begins operations for the drilling of a well on the property then covered hereby, or (b) pays or tenders to Lessor, or to the depository named in Paragraph 8 hereof, for account of Lessor, the sum of Two Thousand and 00/100 ($2,000.00) Dollars (hereinafter called "rental"). Such payment by Lessee shall cover the privilege of deferring the commencement of operations for the drilling of a well or excavating a mine on the lands above described for twelve (12) months from the rental date. In like manner and upon like payments or tenders, the commencement of drilling operations may be further deferred for like periods successively during the primary term of this lease. All payments or tenders may be made by check or draft of Lessee or any assignee thereof, mailed or delivered on or before the rental date.

5. If during the primary term and prior to discovery of oil, gas, sulphur or other minerals hereunder, Lessee should drill a dry hole or holes on the leased premises, this lease shall not terminate (1) if Lessee commences additional drilling operations within ninety (90) days from the cessation of drilling on said well, or (2) if Lessee resumes the payment or tender of rentals on or before the rental date, if any, next ensuing

* * * *

[243]

AMENDMENT OF OIL, GAS AND MINERAL LEASE

THIS AGREEMENT, entered into by and between Williams, Inc. a Delaware corporation, and Shell Oil Company, a Delaware corporation, hereinafter referred to as Shell,

W I T N E S S E T H, That:

A) WHEREAS, Williams, Inc., a Delaware Corporation, as lessor, granted unto Mrs. Delphine C. Williams, Frank B. Williams, Mrs. Elizabeth Williams Zorthian, Mrs. Leila Moors Williams, L. Kemper Williams, Mrs. Katharine Williams Tremaine, Laurence M. Williams, and Mrs. Lucille Williams Mayfield, as lessee, a certain oil, gas and mineral lease dated July 24, 1952, not yet recorded, covering and affecting the following described land situated in Terrebonne Parish, Louisiana, to-wit:

> 20 acres, more or less, out of Section 36, T-17-S, R-15-E, more particularly described as follows:
>
> Beginning at a point in the northerly boundary of said Section 36, at the most westerly corner of Section 17, said township and range; thence with the common line between said Sections 17 and 36 south 56 degrees 53 minutes east 924 feet to the most southerly corner of said Section 17, being a point at the northwesterly line of Section 16, said township and range; thence south 33 degrees seven minutes west at 315.4 feet passing the most westerly corner of Section 16, 942.9 feet to a corner; thence north 56 degrees 53 minutes west 924 feet to a corner; thence north 33 degrees seven minutes east at 878.3 feet passing the most southerly corner of Section 18, 942.9 feet to the point of beginning, containing 20 acres, more or less;

and

B) WHEREAS, the above named lessees assigned and transferred the above described lease to Shell Oil Company, which is now the holder and owner, as lessee, of said lease; and

C) WHEREAS, Shell desires Williams, Inc., to approve the assignment of said lease to Shell; and

D) WHEREAS, it is now the mutual desire of Williams, Inc., as lessor, and Shell Oil Company, as holder and owner of said lease, as lessee, to amend said lease in certain particulars;

NOW, THEREFORE, it is hereby agreed:

1. The assignment to Shell described in Preamble B hereof of the oil, gas and mineral lease described in Preamble A hereof is hereby approved and the leasehold rights of Shell in said lease are hereby recognized by Williams, Inc.

2. The oil, gas and mineral lease described in Preamble A hereof is hereby amended as follows:

[244]

> (a) The royalty provisions of said lease are hereby amended so that wherever a royalty fraction of one-sixth (1/6) is provided for, such fraction is hereby changed and amended to read "one-fourth (1/4)".
>
> (b) The provisions of Section 11 of said lease are hereby amended so that wherever the fraction one-sixth (1/6) appears such fraction is hereby changed and amended to read "one-fourth (1/4)"; and wherever the

fraction five-sixths (5/6) appears, such fraction is hereby changed and amended to read "three-fourths (3/4)".

(c) Paragraph 18 of said lease is amended to provide that units pooled for the production of gas and condensate shall not substantially exceed 320 acres, rather than 160 acres as is presently provided in said lease;

(d) There is hereby added to said lease the following paragraph numbered 20, which shall supersede any provisions of the lease in conflict therewith;

"Lessee shall commence operations on or before the 15th day of January, 1956, for the drilling of a well on the leased premises and shall drill such well with due diligence until it reaches a total depth from the surface of 9300 feet unless such well encounters oil in paying quantities at a lesser depth, or in default thereof, said lease shall terminate as to oil and all lessee's rights as to oil under said lease shall cease and terminate. Oil shall include any fluid hydrocarbons produced from an oil well as here defined. For the purpose of this section "Oil Well" is defined as any well producing hydrocarbon fluids from a subsurface formation and a portion of all of which said fluids occur under existing reservoir conditions as a liquid in the subsurface formation from which produced, and from which well hydrocarbon liquids are produced with a ratio not exceeding 17,500 cubic feet of gas per barrel. In the event the well herein provided for is unable to reach the depth herein specified because of mechanical condition or because of encountering formations through which, in Shell's opinion, it is impractical to drill, then Shell shall have the right to start a substitute well within 60 days after abandonment of the first and the substitute well shall be considered the same as the first well for all purposes of this agreement."

Except as herein amended, said oil, gas and mineral lease remains in full force and effect as to all of its terms and provisions as originally written.

This instrument is binding on all who sign, their successors and assigns.

THUS DONE AND SIGNED on this 24th day of January, 1955, in the presence of the undersigned competent witnesses.

WITNESSES: WILLIAMS, INC.

....

.... By ....

SHELL OIL COMPANY

....

.... By ....

* * * *

[247]

October 9, 1975

Ms. Sharon G. Province
Commission Staff Counsel
Federal Power Commission
825 North Capitol Street, N.E.
Washington, D.C. 20426

Re: Docket No. RI76-8
Pennzoil Producing Company
Docket No. RI76-10
Shell Oil Company

Dear Ms. Province:

In accordance with the ruling of Judge Samuel Z. Gordon at pages 92-93, and 123 of the Transcript, Shell Oil Company submits the following answers to the interrogatories posed by you in your letter of October 3, 1975. We have agreed by telephone that a map of the operating units in which the two Williams leases are contained will be submitted for the record, and this map will be a partial answer to Questions 1 and 2 and a complete answer to Questions 3 and 9. We believe this map, attached hereto as Appendix A, should be filed as an Exhibit in this proceeding, and request the Administrative Law Judge to admit it as evidence.

The answers to your questions are as follows:

1. (a) D_2 RA SUB
   (b) EE_6 RA SU
   (c) EE_6 RA SUA
   (d) FF RA SUA
   (e) KK RA SUA
   (f) LL RA SUB

[248]

   (g) O SUH
   (h) O SUR
   (i) O SUS
   (j) Y RA SUA
2. (a) D_2 RA SUB
   (b) EE_6 RA SUA
   (c) O SUR
   (d) Y RA SUA
3. See map attached as Appendix A.
4.

Units	Shell's Working Interest — Percentage		
	1934 Lease	1952 Lease	Total
(a) D_2 RA SUB	10.06	2.33	12.39
(b) EE_6 RA SU	0.85	—	0.85
(c) EE_6 RA SUA	3.76	2.47	6.23
(d) FF RA SUA	4.39	—	4.39
(e) KK RA SUA	0.05	—	0.05
(f) LL RA SUB	0.04	—	0.04
(g) O SUH	5.00	—	5.00
(h) O SUR	26.48	5.65	32.13
(i) O SUS	0.42	—	0.42
(j) Y RA SUA	0.08	1.38	1.46

[249]

5. Yes.

6.

Units	Total Gross Oil/Condensate Production — MBBL
(a) D_2 RA SUB	3.8
(b) EE_6 RA SU	—
(1) Southdown No. 1	68.6
(2) Gilbert No. 1	52.5
(c) EE_6 RA SUA	—
(1) R.O.B. No. 40	70.3
(2) Pelican No. A-7	59.4
(d) FF RA SUA	25.5
(e) KK RA SUA	16.8
(f) LL RA SUB	53.1
(g) O SUH	4.1
(h) O SUR	7.0
(i) O SUS	11.9
(j) Y RA SUA	25.1

Note: Except for EE_6 RA SU and EE_6 RA SUA, there is only one well producing on each unit. In order to obtain Shell's Working Interest share of the total gross production, the percentage of Work-Interest shown in the answer to Question 4 should be multiplied by the total production shown.

[249]

7.

Units	Oil/Condensate Unit Value — Dollar/BBL
(a) D_2 RA SUB	8.91
(b) EE_6 RA SU	7.03
(c) EE_6 RA SUA	9.46
(d) FF RA SUA	5.94
(e) KK RA SUA	5.52
(f) LL RA SUB	7.71
(g) O SUH	5.36
(h) O SUR	5.56
(i) O SUS	10.77
(j) Y RA SUA	10.35

8.

Units	Shell Sales — MMCF			
	30.1125¢	31.1125¢	58.8595¢	59.8855¢
(a) D_2 RA SUB	23.8	47.9	—	—
(b) EE_6 RA SU	8.1	5.9	10.2	5.7
(c) EE_6 RA SUA	139.8	57.5	136.3	62.4
(d) FF RA SUA	45.3	16.6	—	—
(e) KK RA SUA	0.3	—	0.6	0.3
(f) LL RA SUB	0.5	—	1.2	0.6
(g) O SUH	6.0	—	10.5	3.8
(h) O SUR	399.0	134.0	—	—
(i) O SUS	1.3	—	3.0	1.5
(j) Y RA SUA	0.3	—	0.6	0.3

[250]

8. Note: The total of the above volumes does not include Shell's interest in the dissolved gas on acreage included in the original 1934 Lease, and hence is "unitized" with other lease production by law. This production was not attributable to the above units. These volumes, totalling 179 MMCF, were included in the first answer on page one of John F. Bruskotter's Supplemental Testimony.

9. See map attached hereto as Appendix A.

Very truly yours,

T. G. JOHNSON
Thomas G. Johnson
Attorney for Shell Oil
Company

cc: Administrative Law
Judge Samuel Z. Gordon
Federal Power Commission
825 North Capitol Street, N.E.
Washington, D.C. 20426

All Parties

[256]

October 6, 1975

Honorable Samuel Z. Gordon
Administrative Law Judge
Federal Power Commission
825 North Capitol Street
Washington, D.C.

Re: Pennzoil Producing Comapny
Docket No. RI 76-8;
Shell Oil Company, Docket
No. RI 76-10

Dear Judge Gordon:

At the hearing held in the above referenced docket on September 23, 1975, Mr. A. Duncan Gray, Jr. testified on behalf of Pennzoil Producing Company. A portion of his testimony concerned calculations based on volumes of production. As a result of an effort to update the numbers involved, it was discovered that the volumes upon which the calculations had been based were in error. The enclosed affidavit of Mr. Gray sets forth the necessary corrections.

Very truly yours,

STEPHEN M. HACKERMAN
Stephen M. Hackerman

SMH:120
enclosure
cc: All Parties of Record

[257]

AFFIDAVIT

THE STATE OF TEXAS }
COUNTY OF HARRIS }

A. Duncan Gray, Jr., being duly sworn, deposes and says:

I have previously testified in Pennzoil Producing Company and Shell Oil Company, Docket Nos. RI 76-8 and 76-10. That testimony appears at pages 23-42 of the transcript in that proceeding. Included in that testimony were a number of calculations based on Producing's production volumes. Subsequent to the date on which this testimony was taken, Producing undertook to update the data upon which the calculations were based. As a result, it was discovered that a number of the original calculations were based on incorrect volumes. The following corrections are therefore necessary:

1. On page 26, line 48, reference is made to the fraction of gas sold by Producing from the Williams lease which qualifies for the national new gas rate under Opinion No. 699-H. That fraction is roughly one-half rather than one-third. This same correction should also be made at page 38, line 12-13.

2. On page 27, line 11, reference is made to the price increase per Mcf for volumes delivered from July, 1975 through the end of 1975 if the royalty flow through is approved. That figure for the period July, 1975 through June 1976, is 3.6467¢ per Mcf. In addition the surcharge, if placed into effect on July 1, 1975 will be 6.3291¢ per Mcf rather than 8.645¢ (page 27 line 5), 2.8753 rather than 5.4205¢ of that total attributable to volumes delivered during the first six months of 1975 (page 5, line 13) and 3.4538¢ rather than 3.2252¢ attributable to 1974 deliveries (page 5, line 15).

[258]

In addition at pages 31 and 32, there are a number of references to the average price for gas sold by Producing from the Williams lease under a variety of circumstances, all without Btu adjustment or tax reimbursement. The reference should be to the average price for gas sold by Producing from the Gibson field, without adjustments. These figures are as follows.

1. The current average price is approximately 40.9103¢ per Mcf rather than 36¢ (page 31, line 21). This figure is based on the projected volume of deliveries for the period July 1, 1975 through June 30, 1976 and does not include an adjustment for the 1 cent escalation to be effective January 1, 1976 for new gas sold under Opinion No. 699-H.

2. If the royalty flow through is allowed, the average price would be 44.6¢ per Mcf rather than 44¢ per Mcf (page 31, line 25).

3. The average price if both the flow through and the surcharge is approved would be 50.9¢ per Mcf for the next twelve months and 44.6¢ thereafter rather than 52¢ and 44¢ respectively (page 32, lines 6-7).

A. DUNCAN GRAY, JR.
A. Duncan Gray, Jr.

SUBSCRIBED AND SWORN TO, before me, this 6th day of October, 1975.

MARY SCHRAAK FORESTER
Notary Public in and for
Harris County, Texas

[338]

UNITED STATES OF AMERICA
FEDERAL POWER COMMISSION

Pennzoil Producing Company

Docket No. RI76-8

Shell Oil Company

Docket No. RI76-10

PRESIDING ADMINISTRATIVE LAW JUDGE'S INITIAL DECISION DENYING PETITIONS FOR SPECIAL RELIEF OR, IN THE ALTERNATIVE, FOR ABANDONMENT

(November 24, 1975)

* * * *

Administrative Law Judge Gordon, presiding:

1

STATEMENT AND PROCEDURAL BACKGROUND

Shell Oil Company (Shell) and Pennzoil Producing Company (Pennzoil) sell gas produced from the Gibson Field, Terrebonne Parish, Louisiana, to United Gas Pipe Line Company (United) under their FPC Rate Schedules Nos. 202 (Shell) and 234 (Pennzoil). A portion of the gas sold by Shell to United is produced from acreage covered by a mineral lease dated August 29, 1934 (the 1934 lease, Ex. 9) from F. B. Williams Cypress Company (now Williams, Inc.) to Shell Petroleum Company (now Shell), and by a mineral lease dated July 24, 1952 (the 1952 lease Ex. 10) from Williams, Inc. to certain persons who assigned the lease to Shell in January 1955. This assignment was

approved by Williams, Inc. on January 24, 1955 (Ex. 10, pp. 30-31). A portion of the gas sold by Pennzoil to United is produced from a part of the 1934 lease acreage which was subleased by Shell to Union Producing Company (now Pennzoil) on December 29, 1942. Certain acreage from the 1934 lease has been unitized.

[339]

The 1934 and 1952 leases and the royalty demands of the lessor, Williams, Inc., thereunder, give rise to the issues in this proceeding.

The 1934 lease provides for payment of royalty on the gas produced thereunder equal to "one-eighth (1/8) of the value thereof, calculated at the market rate prevailing at the well" (Ex. 9, sec. 4). The 1952 lease, as amended on January 24, 1955, provides for payment of royalty on the gas produced thereunder equal to "one-fourth (1/4) of the value thereof, calculated at the market price prevailing at the well" (Ex. 10, sec. 3; Amendment of January 24, 1955, Ex. 10).

By letters dated June 7, 1973 (Ex. 1) and March 27, 1974 (Ex. 2), Williams, Inc. demanded payment by Shell and Pennzoil of royalties based on market values ranging from 35 cents to 70 cents for the period from October 1, 1971 through December 31, 1973, and at the 70 cent price thereafter — all of which prices exceeded the ceiling rates which had been established by the Commission for the Southern Louisiana Area, of which the Gibson Field is a part. By letter of June 5, 1974 (Ex. 3) Williams, Inc. declared that the 1934 and 1952 leases were terminated for non-payment of proper royalties.

Prior to receipt of Williams' June 5, 1974 letter, Shell and Pennzoil, on May 24, 1974, filed a petition in the Civil District Court in the Parish of Orleans, Louisiana (*Shell*

Oil Company and Pennzoil Producing Company v. Williams, Inc., et al., Docket No. 573-591) praying for a judgment declaring that Shell and Pennzoil were paying the appropriate royalty and for a preliminary injunction, pending disposition of the suit, to enjoin Williams, Inc. from taking any efforts to interfere with Shell's and Pennzoil's possession and operation of the leased properties. Such a preliminary injunction was granted (see Ex. 3). By Reconventional Demand (counterclaim) Williams requested *inter alia*, cancellation of the 1934 and 1952 leases, effective June 5, 1974, payment of the value of all oil, gas and minerals extracted from the properties after said dates, and payment of damages from Shell and Pennzoil in excess of $1.5 million for alleged past underpayment of royalties (Ex. 5). The asserted underpayment was calculated on the basis of market prices ranging from 35 cents to 70 cents per Mcf for the period from October 1, 1971 through May 31, 1974. Williams, Inc. amended its reconventional demand on June 27, 1975 to request

[340]

damages of almost $1,990,000 from Pennzoil and almost $198,000 from Shell covering alleged royalty underpayments from June 1, 1974 through April 30, 1975 on the basis of market prices ranging from $1.30-$1.40 per Mcf for the period from June 1, 1974 through April 30, 1975 (Ex. 6).

Shell, Pennzoil and Williams, Inc. have entered into a Settlement Agreement dated June 18, 1975 (attached to Shell's Petition as Appendix A) which will terminate the litigation and permit Shell and Pennzoil to retain both the 1934 lease and the 1952 lease upon the payment of higher royalties to Williams, Inc. or, in the alternative, upon abandoning to Williams of the royalty interests in the gas. The Settlement Agreement provides that Shell and Pennzoil will make such applications to the Federal Power Commis-

sion as may be necessary to obtain authorization for the following:

(A) Payment by Shell and Pennzoil of royalty on each Mcf produced and sold under the 1934 lease and under the 1952 lease, equal to one-eighth (1/8th) in the case of the 1934 lease and one-fourth (1/4th) in the case of the 1952 lease, of the total of:

(1) the higher of (a) the base royalty rate, or (b) the base alternative rate, plus

(2) seven (7) cents or the full amount of the Louisiana severance tax, which amount is to be increased as the severance tax of the State of Louisiana is increased, plus

(3) the full amount of Federal taxes imposed upon Williams, Inc., plus

(4) any upward or downward adjustment for Btu content of the gas containing more or less than 1,000 Btu per cubic foot, and

pass through to United of the portion of such total which exceeds current royalty payments by Pennzoil and Shell to Williams, Inc.

In connection with the above, "base royalty rate" is 78 cents per Mcf as of January 1, 1975, increasing 1.5 cents per Mcf each January first beginning January 1, 1976, "Base alternative rate" is 150 percent of the highest area or national rate permitted or, in the case of deregulation of interstate gas sales, is the average of the three (3) highest prices provided in sales for resale in the Southern Louisiana Area; or, in the alternative,

[341]

(B) Abandonment of that share of the gas sold under said leases which is attributable to Williams, Inc. royalty interests (i.e., 1/8 and 1/4 of the gas produced under the 1934 and 1952 leases, respectively), said share to be delivered to Williams, Inc. in kind for use or sale in any market.

In addition, the Settlement Agreement provides that Shell and Pennzoil shall pay to Williams, Inc. the sum of the royalty which would have been paid during 1974 if Shell's and Pennzoil's sales price during such period had been 45 cents per Mcf, less royalty actually paid (but only to the extent that the Commission permits Shell and Pennzoil to recover such amounts from United), plus the royalty due if the Commission approves (A) above, all as more fully set out in Section II of the Settlement Agreement attached to Shell's Petition as Appendix A.

United has expressed its agreement to the Settlement Agreement by consenting, upon Commission approval, to amending its gas purchase contracts with Shell and Pennzoil to pay the increased rates called for by the Settlement Agreement or, in the alternative to release one-eighth of the gas if the abandonment to Williams, Inc. is authorized by the Commission (Exs. 7, 8, Tr. 52-57).

Thereafter, and pursuant to the terms of the Settlement Agreement, on July 1, 1975 and July 18, 1975 Pennzoil and Shell, respectively, filed the instant petitions, Docket Nos. RI76-8 and RI76-10, seeking special relief from the just and reasonable rates established under Opinion Nos. 598 and 699 in order to flow through to United the higher royalty rates called for in the Agreement or, in the alternative, if said relief is denied, to abandon to Williams, Inc. one-eighth of the gas produced under the 1934 lease and one-fourth of the gas produced under the 1952 lease. In addition,

Pennzoil and Shell seek approval to impose a retroactive surcharge, as provided for in the Settlement Agreement, against United for gas deliveries made from January 1, 1974 to the effective date of the Commission's order. The petitions seek Commission action no later than February 1, 1976, the date on which, failing favorable action by the Commission upon the petitions, Shell, Pennzoil or Williams, Inc. may terminate the Settlement Agreement. In view of this time limitation, the petitions sought expedited procedures, including waiver of the initial decision.

[342]

In its order issued August 29, 1975, the Commission found "[t]here is no justification for allowing a producer to pass through higher royalty costs to the consumer without a showing that Petitioners' overall costs are higher than those reflected in our Opinion No. 699-H" (Order, p. 3) and thereupon denied "[t]hose portions of the petitions . . . relating to a request for rate increases due to increases in royalty payments" (Order, p. 4). Finding that "[t]here is no basis for allowing a temporary surcharge for the purpose of permitting a producer to recover retroactive royalty payments" (Order, p. 3), the Commission denied those portions of the petitions relating to the surcharge (p. 4). The Commission set down for hearing and decision the sole issue of the requested abandonment of the royalty owners' interests in the gas, and consolidated the two petitions for this purpose (Order, pp. 3, 4). The Commission denied the request for waiver of the initial decision, but directed that the same be filed on or before November 26, 1975, with the hearing to commence on September 23, 1975.

Thereafter, on September 9, 1975, Pennzoil filed an application for rehearing of the August 29 order, pointing out that the Commission's summary denial, without a hear-

ing, of its request for special relief on the market value royalty issue was inconsistent with Commission action in other cases, and constituted unlawful discrimination against it. Pennzoil stated it "does not contend that the orders issued in the *Huffington* and *Exxon* cases establish the propriety of the rate increase based on increased royalties which Pennzoil seeks in this case. That can only be established by the presentation of evidence. Without question, however, the *Huffington* and *Exxon* orders do establish Pennzoil's right to present the evidence which will justify the rate increase request." (Application for rehearing, p. 4.)

In its order issued on September 22, 1975 the Commission recognized that Pennzoil's rate increase request based on higher market value royalty payments presented similar issues to those raised in *Huffington* (Docket No. CI75-602) and since an evidentiary hearing had been set in that case, the same treatment should be afforded here. Accordingly, the Commission granted Pennzoil's application for rehearing, applied the same ruling (on its own motion) to Shell, and vacated "[t]hat portion of the August 29, 1975 order denying Pennzoil's and Shell's petitions for special relief." The Commission did not, however, vacate that portion of its August 29 order denying the petitions'

[343]

requests to impose a temporary surcharge based on past royalties. Since the Commission did not change the scheduled date for the hearing, which was set for September 23, it provided in its September 22 order that Shell should be afforded such additional time as might be fixed by order of the Presiding Administrative Law Judge for filing any additional testimony and evidence relating to its request for authorization to collect increased rates. No similar dispensation was made for Pennzoil since it had

represented that it had already submitted such evidence in its petition for special relief.

The hearing was held on September 23, 1975, at which time Shell, Pennzoil and United adduced the testimony of witnesses and presented documentary evidence. Shell was afforded additional time to present certain factual data as to prices, volumes and costs, and it presented such material for the record under covering letter dated September 26, 1975 (Additional Prepared Testimony of John F. Bruskotter, received in evidence as late-filed Exhibit 10). Shell was to file any additional cost data which it might wish to submit for the record by October 3, and, if it did so, a further hearing would be held on October 8 (Tr. 121-2). However, Shell advised that it did not intend to file any additional cost data (Additional Prepared Testimony of John F. Bruskotter, p. 3 (Ex. 10). Certain of the data filed by Shell after conclusion of the hearing on September 23 provoked some questions by the Staff, and, pursuant to arrangements made at the hearing, Staff filed written interrogatories directed to Shell on October 3 (late-filed Ex. 11(a)). Shell's written answers to said interrogatories were filed on October 10, 1975 (late-filed Ex. 11). On October 6, 1975, Pennzoil filed an affidavit by its witness A. Duncan Gray, Jr. correcting certain of his testimoney as to prices, volumes and dollar effects of the requested royalty increases (late-filed Ex. 13).

Initial briefs and reply briefs were mailed on or about October 21 and October 28, 1975, by the parties and certain of the intervenors.

[344]

II

THE ISSUES

The issues are:

1. Whether Pennzoil and Shell have met their burden of establishing they are entitled to special relief from the area (Opinion 598) and nationwide (Opinion 699-H) just and reasonable rates established by the Commission because, pursuant to an agreement entered into with the lessor for settling pending litigation in the state court involving the lessor's claim to payment of royalties based on market values in excess of the Commission's ceiling rates, their royalty costs will be increased, in the absence of their establishing that their overall costs of producing gas from the acreage in question will exceed the ceiling rates or that their out-of-pocket expenditures will exceed revenues. Implicit in this issue is the question of what are the legal standards governing the granting of such special relief.

2. Whether, failing the grant of the requested special relief, Pennzoil and Shell have met their burden of establishing that abandonment of the royalty owner's share of the gas is authorized by the present or future public convenience and necessity, where such abandonment is called for, as an alternative, in the aforesaid settlement agreement.

3. Whether assuming *arguendo* that the issue of a surcharge for past royalties is still open under the Commission's orders herein, such a surcharge may be lawfully and properly imposed by Pennzoil and Shell against United when to do so would, in effect, impose a retroactive increase above area and nationwide ceiling rates.

[345]

III

PENNZOIL AND SHELL ARE NOT ENTITLED TO SPECIAL RELIEF FROM THE AREA AND NATIONWIDE CEILING RATES ESTABLISHED BY THE COMMISSION

In essence, the proposed Settlement Agreement of June 18, 1975, entered into between the producers-lessees, Pennzoil and Shell, and the lessor, Williams, Inc., provides that royalties will be computed on the basis of 78 cents per Mcf (plus 1.5 cents per Mcf for each year beginning January 1, 1976), that Shell and Pennzoil will pay Williams one-eighth of that amount for gas produced under the 1934 lease, and that Shell will pay Williams one-fourth of that amount for gas produced under the 1952 lease (Pennzoil is not a lessee or sub-lessee under the 1952 lease and has no royalty obligation thereunder). Pennzoil and Shell seek permission herein to obtain from the gas purchaser, United, higher prices than the Commission-established ceiling area rates (Opinion No. 598) and nationwide rates (Opinion No. 699-H) in order to flow through, on a cents-for-cents basis, the higher royalty payments which they would be making to Williams pursuant to the Settlement Agreement. United has agreed, upon Commission approval, to pay such higher prices. Either Williams or Pennzoil and Shell, acting together, has the option, under the terms of the Agreement to terminate the same if the Commission, by February 1, 1976, does not authorize the special relief herein requested as to future royalty flow through (discussed in Section III) or the abandonment alternative (Section IV, *infra*). No such option to terminate the Settlement Agreement is retained if the Commission refuses to approve the surcharge (Settlement Agreement, Section VIII A; Section V, *infra*).

Of course, if Pennzoil and Shell prevailed in the state court litigation and it were held that the "market value" did not exceed the Commission's established ceiling prices, this would end the matter since Williams would not be entitled to any higher royalties than that paid to it and Pennzoil and Shell would not be seeking any special relief from the ceiling prices in order to pay Williams any greater royalties.

[346]

A. *Position of Pennzoil and Shell*

Pennzoil and Shell have testified that they view the state court litigation seriously and, while they have not attempted to measure their chances of prevailing on the merits, they have sought to eliminate the risks of the litigation by entering into the Settlement Agreement.[1] The Agreement, they argue, is just and reasonable and in the public interest because (a) the 78 cent price for computing royalties is less than the intrastate price which ranges from $1.10 to $1.58 per Mcf (Tr. 63, 64), (b) the higher rates requested by way of special relief in order to flow through the higher royalty costs would amount, in the case of Shell, to 3.6 cents per Mcf under the 1934 lease and 9 cents per Mcf under the 1952 lease (based on Shell's average prices in the year ended April 1, 1975 — Additional Prepared Testimony of Bruskotter, pp. 1-2, Ex. 10), and, in the case of Pennzoil, would amount to 3.6 cents per Mcf (based on projected volumes from July 1975 through June 1976 — Affidavit of Gray, Ex. 13)[2] and (c) implementation of the

[1] Apart from anything else, the settlement would extinguish, at no cost to Pennzoil and Shell, Williams' claims for damages for alleged underpayment of past royalties amounting to approximately $1,990,000 against Pennzoil and approximately $198,000 against Shell.

[2] The above data both for Shell and Pennzoil do not reflect any price increases for the surcharge, which, in the case of Pennzoil, would amount to 6.33 cents per Mcf for one year (Affidavit of Gray, Ex. 13). No data as to the Shell surcharge amount were presented.

settlement would permit Shell and Pennzoil to retain both leases and avoid any diversion of gas from the interstate market.[3]

[347]

In contrast, if Williams prevailed in the state court litigation, Pennzoil and Shell argue that this might result in the leases being cancelled and, if Williams were then free to sell the gas in any market, a diversion of all the gas from the interstate market. Even if Williams still had to sell the gas in the interstate market, he might be able to sell it at the small producer rate of 130% of the nationwide rate, or he could sell all the gas at the nationwide rate — prices, which, in either event, are higher than the prices resulting from the settlement. Furthermore, if Williams won in the state court on his claim that market value meant prices in excess of the Commission ceilings, but the court did not decree lease cancellation, Pennzoil and Shell would have to pay royalties based on $1.40 or more per Mcf or above and such higher costs (plus damages for past underpayment of royalties) might then have to be passed on to their customer, United.

Finally, Pennzoil and Shell urge that the Settlement Agreement with Williams should be implemented since it will remove the cloud of litigation and thus will enable them to proceed with development plans on the leases.

B. *Reasons for Denying Special Relief*

The foregoing arguments and position of Shell and Pennzoil have certain attractions but they suffer from some basic flaws, many of which are pointed out by the Commission Staff and by intervenor, Michigan Pipe Line Company, in their briefs.

---

[3] United generally supports the position of Shell and Pennzoil.

First, the law is clear, both from Commission and court decisions, that a producer seeking special relief from area or nationwide prices based on asserted increased costs must establish that his overall costs incurred in the operation of the particular well or group of wells are higher than the applicable Commission-established area or nationwide ceiling rates, or, even more stringently, that his out-of-pocket expenses will exceed revenues. *Permian Basin Area Rate Proceedings*, 34 FPC 159, 226 (1965), affirmed, *Permian Basin Area Rate Cases*, 390 U.S. 747, 770-773 (1968); Opinion 598 (Southern Louisiana Area rates), mimeo at 70, 18 CFR § 154.105(j), affirmed, *Placid Oil Company v. Federal Power Commission*, 483 F.2d 880, 910-911 (5th Cir., 1973), affirmed *sub nom. Mobil Oil Corp. v. Federal Power Commission*, 417 U.S. 283, 328 (1974); Opinion 699 (Nationwide Area rates), mimeo 105-106, 18 CFR 2.56a(g), affirmed, *Shell Oil Company v. Federal Power Commission*, Nos. 74-3330 et al. F.2d (5th Cir., October 14, 1975) slip. at 168; *McDonald v. Federal Power Commission*, 505 F.2d 355 (C.A.D.C. 1974),

[348]

cert. denied sub. nom., *George Mitchell and Associates, Inc. v. Macdonald*, 421 U.S. 912 (1975); *Consumers Union of U.S., Inc. v. Federal Power Commission*, 510 F.2d 656, 660 (C.A.D.C., 1975); *Terra Resources, Inc.*, 51 FPC 876 (1974); *Continental Oil Company*, Docket No. RI74-108, order of May 15, 1974; *Ashland Oil, Inc.*, Docket No. RI74-40, Order of May 15, 1974.

Thus, in Opinion 699 (June 21, 1974) the Commission pointed out that its previous area rate opinions provided for special relief in unusual circumstances where the area rate was not sufficient to recover the cost of producing natural gas already dedicated to the interstate market. The Commission stated (mimeo at 105-106):

"Without attempting to enumerate all circumstances which would form an adequate basis for granting special relief, we shall grant special relief where the producer can demonstrate that the out-of-pocket expenses incurred in the operation of a particular well (or group of wells) are greater than revenues from the sale of the subject gas. See, *Permian Basin Area Rate Cases*, 390 U.S. 747, 770-773.

"It is incumbent upon the producer seeking special relief to prove by his books and accounts that the operating expenses are in excess of the revenues earned from the sale of the gas from such well or wells.

"There are also other avenues of extraordinary relief for a producer who may be adversely affected by the rate established in this proceeding. Where a producer has already dedicated gas to the interstate market and a change in circumstances makes continued production uneconomical, the producer

[349]

may seek relief under our Order No. 481,[144] or Order No. 482,[145]. Where the producer has not already committed the subject acreage of gas supply to the interstate market, he may seek certification of the sale under Order No. 455." [18 CFR § 2.75; Optional Procedure for Certificating New Producer Sales of Natural Gas]

[144] 18 C.F.R. § 2.76; *Policy with Respect to Sales Where Reduced Pressures, Need for Reconditioning, Deeper Drilling, or Other Factors Make Further Production Uneconomical at Existing Prices*, Docket No. R-458, 49 F.P.C. 992 (1973), as amended by *Order Amending Order No. 481 and Granting and Denying Petitions for Rehearing*, 49 F.P.C. (June 8, 1973).

[145] 18 C.F.R. § 2.77; *Flaring and Venting of Natural Gas*, Docket No. R-459, Order No. 482, 49 F.P.C. 996 (1973)."

In *Macdonald* v. *FPC, supra*, the court remanded the Commission's decision approving a settlement agreement granting special relief from area rates for "reconsideration of the reasonableness of Mitchell's [the producer's] settlement agreement in light of a full evidentiary record on Mitchell's costs of production in the Wise County contract region and the profits which it can expect to obtain over the life of its new and old wells in this region." (505 F.2d at 365)[4]

[350]

Even under the 2.75 optional procedure,[5] which might be thought to provide more liberal criteria for affording higher than area or nationwide rates as a means to induce new dedications of gas to the interstate market, the court in *Consumers Union of U.S., Inc.* v. *Federal Power Commission, supra*, in remanding the Commission's decision approving higher rates, pointed out that applicants' cost showing was inadequate and stated (at 660): "Even after *Permian* and *Mobil Oil*, it is doubtful that non-cost factors can sustain a decision by the FPC which is unsupported by sound cost data."

In approving the nationwide rates established by the Opinion 699 series of orders, the Court of Appeals in *Shell*

[4] *Cities of Fulton et al., Missouri* v. *FPC*, 512 F.2d 947 (C.A.D.C. 1975), relied upon by petitioners, is not to the contrary since, *inter alia*, applicant there was not seeking higher than area or nationwide rates and, as pointed out by the court, there were sufficient cost data presented (at 952).

[5] The instant petitions for special relief are not filed under 18 C.F.R. 2.75 (nor 18 C.F.R. 2.76) but under the special relief procedures in the Southern Louisiana Area Rate (18 C.F.R. 154.105) and the nationwide rate (18 C.F.R. 2.56a) orders. Section 2.75 is clearly inapplicable since, among other things, the instant petitions are for rate relief on the gas produced under the Williams' leases from wells commenced long before April 6, 1972 and the gas had previously been sold in the interstate market. Section 2.76 would appear to be inapplicable. See *Terra Resources, supra*.

Oil Company v. *Federal Power Commission,* supra stated (slip. op. at 168):

> "First, the order made provisions for special relief in unusual circumstances where the rate is not sufficient to recover the cost of producing natural gas already dedicated to the interstate market. The burden is on the producer with the above average costs to justify an additional price for its gas. This is not the only avenue of extraordinary relief for producers who may be adversely affected by the national rate structure, however. The FPC has standing regulations which afford relief to producers who face an increase in costs. 18 C.F.R. § 2.76 (1974)."

[351]

The Supreme Court in *Mobil Oil Corp.* v. *F.P.C.,* 417 U.S. 283 (1974) affirmed the Fifth Circuit's affirmance (*Placid Oil Company* v. *Federal Power Commission,* 483 F.2d 880 (1973)) of the Commission's Southern Louisiana Area Rate order, Opinion 598. Both courts specifically addressed the problem of market value royalty lease clauses as affecting area ceiling rates and special relief therefrom. Thus the Supreme Court stated (at 328):

> "Mobil also complains that the Commission failed to provide automatic adjustments in area rates to compensate for anticipated higher royalty costs. It relies on *Mobil Oil Corp.* v. *FPC,* 149 U.S. App. D.C. 310, 463 F.2d 256 (1972) where the Court of Appeals for the District of Columbia Circuit reversed a Commission holding that subjected royalties to FPC administrative ceilings. Mobil argues that under that decision the 1971 rate schedules must take into account the possibility of higher royalty obligations. We agree with the Court of Appeals that Mobil's argument is hypothetical at this stage and that in any event an affected producer is entitled to seek individualized relief. The Court of Appeals said:

> '[W]e are not willing to alter or stay the implementation of area wide rates for the entire industry merely on the basis of what *might* happen to *some* producers' costs *if* [the D.C. Circuit's] statement of the law prevails.
>
> If, as subsequent events develop, the producers are put in a bind by their royalty obligations, they may certainly petition FPC for individualized relief. *Permian* contemplated it.' 483 F.2d. at 911 (emphasis in original)."

On the same matter, the Court of Appeals below had added (*Placid Oil* at 911):

> "If the royalty obligations are such as to make the rates established by Op: 598, and approved by us here, confiscatory or otherwise inappropriate, those producers who are materially affected will certainly have recourse to the administrative process."

[352]

Second, it is plain from the foregoing that petitioners here must prove, as a condition precedent to obtaining special relief from the area and nationwide ceiling rates, that their overall costs with the increased royalty payments will be greater than the ceiling rates or that their out-of-pocket expenditures will exceed revenues. However, Pennzoil and Shell have not met their burden of proof. Pennzoil has made no showing whatever as to its overall costs or out-of-pocket expenditures from operations under the 1934 Williams lease. It has not even attempted to make such a showing. For this reason alone, Pennzoil's petition for special relief must be denied.

Nor is it any answer to Pennzoil's failure to make the requisite cost showing (which would help establish that it is "in a bind" because of the higher royalty payments it may have to make to Williams) for Pennzoil to claim (Tr.

26) that by paying Williams more in royalties it will have that much less to spend on exploration and development. On that basis every gas producer faced with any increased cost of production (whether stemming from higher royalties or increased labor, material or other costs) would be entitled to prices in excess of the Commission ceiling rates. Moreover, Pennzoil has made no firm commitment here to undertake increased exploration and development as a possible *quid pro quo* for a rate increase and has not even attempted to establish projected costs and revenues from any such activity. (See the *Macdonald* and *Cities of Fulton* cases, *supra*). It has merely stated that it has plans in 1976 for one development well and one work-over of an existing well, with reserves of 1.65 Bcf and 2.42 Bcf of gas, respectively, and that these plans will be deferred indefinitely if it had to pay royalties on the basis of $1.40 per Mcf or above while the available price for the gas was 52 cents (Tr. 30-31). Significantly, Pennzoil did not testify that it would defer these plans if royalties were paid on the basis of the 78 cents per Mcf settlement price and the gas price remained at 52 cents.

In contrast to Pennzoil, Shell did make an effort to adduce some evidence as to its costs of operations and revenues under the 1934 and 1952 Williams leases.

Shell asserts that its current operating costs (based on the first five months of 1975) on the two leases are 4.5 cents per Mcf. This is an average cost for the entire Gibson Field and the Williams leases are included in 10 separate operating units in that Field. However, since the Williams leases are representative of the entire Field, the Field average cost is properly allocated to the Williams leases. The 4.5 cents figure includes direct lease cost, reconditioning and recompletion

costs, overhead, and property taxes and insurance. It does not include amortization of capital investment, federal income taxes, return on capital investment, royalties or severance taxes. (Tr. 85, 86, 94, 95, 102-107; Additional Prepared Testimony of Bruskotter, pp. 2, 2a, 3, Ex. 10.) The 4.5 cents figure may be accepted for the purpose of this proceeding since it was not challenged. Although termed an "operating cost" by Shell, it includes more than out-of-pocket expenditures since, at the least, it includes overhead.

However, Shell adduced no testimony as to its capital costs attributable to the Williams leases, although the record was held open for ten days (from September 23 to October 3) for it to do so, and in the event it wished to adduce such cost or other cost data, provision was made to hold a further hearing in the matter on October 8. Shell, however, did not avail itself of this opportunity, and instead sought to use the average nationwide costs embodied in Opinion 699-H, merely "slotting-in" the 4.5 cents figure of its own operating costs and a royalty figure computed on the basis of the $1.40 per Mcf "market value" Williams had claimed.[6]

---

[6] Shell states that because of the time constraints of this proceeding and the complexities of the Gibson Field with its numerous operating units, reservoirs at different depths, and leases in operation since 1934, it could not, within the limited time, adduce data as to ts capital costs attributable to the Williams leases (Ex. 10, Additional Prepared Testimony of Bruskotter, p. 3; Shell's Initial Brief, pp. 12, 13). However, Shell (and Pennzoil) had requested the accelerated procedure, it had since the filing of its petition in mid-July to prepare for an expected hearing, and, clearly, no one is in as good a position as Shell to establish what are its overall costs, including capital costs. In effect, Shell is making the astonishing claim that it does not know, and cannot ascertain without a superhuman effort, what are its overall costs under the Williams leases which it has been operating since 1934 and 1955.

Such a slotting-in procedure is improper. Since the Opinion No. 699 cost data are based on nationwide averages, there must be very numerous producers experiencing certain costs which are above the nationwide averages, but whose total costs are not. By selecting only their higher cost items and using the other costs reflected in Opinion No. 699, all such

[354]

producers would be entitled to rate increases. This would make a mockery of the nationwide rates. The Commission has rejected such a methodology. "In a case of this nature, *i.e.*, a case wherein special relief from area rates is sought, evidence of area, or national, costs and productivity is inappropriate." (*Continental Oil Company,* Docket No. RI74-108, March 15, 1974.) And clearly, such a method would be contrary to the authorities cited above on the need for adducing individualized cost data to justify special relief. The case of *The Rodman Corporation,* Docket No. CI73-694, relied upon by Shell, is not to the contrary since even in that § 2.75 optional procedure case the Commission relied on project cost studies done by the company's witness, in addition to considering the average nationwide costs. (Opinion No. 736, mimeo p. 4.)

Using the 4.5 cents per Mcf figure for operating costs and other data supplied by Shell as to prices and volumes, the Staff has computed that Shell would earn a yearly profit, without an increase over area and nationwide rates, of $178,951[7] (based on the twelve months ended April 1, 1975) from gas operations under the 1934 and 1952 Williams leases (Staff's Initial Brief, Attachment A; the typographical error in the profit figure ($78,951 should be

[7] The profit of $178,951 does not reflect any capital costs of Shell since, as noted, Shell did not adduce any data as to its own capital costs.

$178,951) was corrected in Staff's Reply Brief, p. 2). This profit assumes that Shell's royalty payments to Williams under the two leases are based on 78 cents per Mcf, the figure which Williams has agreed to accept in the Settlement Agreement.

The foregoing calculations are proper and sustained by the evidence in this proceeding.

In addition, the Staff has calculated, on the basis of data supplied by Shell, that Shell's annual condensate revenues attributable to the two Williams leases would amount to $112,664 (Staff's Initial Brief, Attachment B). These figures were not challenged by Shell and they are accepted herein as in accordance with the evidence in this proceeding. Thus, in addition to an annual profit (exclusive of capital costs) of $178,951 earned

[355]

by Shell from gas operations attributable to the Williams leases, without any price increases above the area and nationwide rates, and assuming royalties were calculated on the basis of the 78 cents Settlement Agreement figure, Shell would also earn $112,664 in yearly revenues from condensate sales attributable to those leases.[8]

Patently, at the 78 cents per Mcf royalty basis agreed to in the Settlement, Shell would be recovering considerably more than its out-of-pocket expenses at the area and nationwide ceiling rates.[9] Hence, Shell's petition for special relief must be denied. If the test for special relief is that Shell must be permitted to recover its overall total costs

[8] Condensate revenues are properly a credit against gas production costs (see Opinion No. 699, mimeo pp. 91-92).

[9] Shell asserts (Initial Brief, p. 8) that if Williams won the state lawsuit (i.e., if royalties are computed on the basis of $1.40 per Mcf), Shell's net revenue on the 1934 lease would be 10.875 cents per Mcf (with no allowance for capital costs) and that it would

(including capital costs), Shell's petition for special relief must be denied because it has failed to sustain its burden of establishing that its overall total costs exceed the area and national rates.

Shell's contention that royalties must be based on the $1.40 per Mcf claimed by Williams, rather than on the 78 cents per Mcf which Williams has agreed to in the Settlement Agreement, is rejected. For Williams has formally agreed to accept the 78 cents figure as the basis for computing its ⅛ or ¼ royalty share in full settlement of its claims in the state court litigation. Williams is not concerned with whether

[356]

Shell (or Pennzoil) can flow through the higher royalty payments to United and on this score the petitions' requests for special relief to permit the flow through are solely for the benefit of Shell and Pennzoil. Thus, if the Settlement Agreement is terminated because of failure to grant the requested special relief royalty flow-through, it will be at the choice of Shell or Pennzoil, not Williams. But even at a $1.40 per Mcf royalty base, Shell has shown that it will recover $55,850 a year more than its out-of-pocket costs (Shell's Reply Brief, Appendix A), to which should be added $112,664 a year in condensate revenues (Staff's Initial Brief, Attachment B). (This comes to a total of $168,514 in net annual revenues to Shell, the figure cited by Shell in its Reply Brief, p. 7.)

suffer a net loss of 3.15 cents per Mcf on the 1952 lease (with no allowance for capital costs). On the basis of 78 cents per Mcf in the Settlement, these figures would translate to 18.625 cents per Mcf net revenue on the 1934 lease and 12.35 cents per Mcf net revenue on the 1954 lease. (On the 1934 lease royalty costs would be ⅛ of 78 cents rather than ⅛ of $1.40; on the 1952 lease, royalty costs would be ¼ of 78 cents, rather than ¼ of $1.40.)

Third, Shell's contention that special relief should be granted to permit the increased royalty flow-through to United since otherwise it will have less funds to expend on exploration and development, is rejected for reasons stated above in connection with Pennzoil's similar contention. Moreover, it should be noted that Shell has made no commitment to engage in additional exploration and development should the requested relief be granted. Shell had planned to drill a new well on the 1934 Williams lease, but it was the "cloud" of the Williams litigation which delayed the work. The most Shell would say is that "if, as and when the cloud of this litigation is removed, Shell will reevaluate the feasibility of drilling this well." (Tr. 79.)

Fourth, the fact that the instant petitions for special relief come before the Commission in the garb of an agreement between producers and lessor in compromise settlement of the state court litigation, does not entitle the petitions to any greater weight. For while the Commission as well as the courts favor compromise settlements to end litigation, the Settlement Agreement here is merely the beginning point rather than the conclusion of analysis. For the ultimate question is whether Pennzoil and Shell can absorb the increased royalty costs resulting from the settlement or whether they must have special relief from the area and nationwide ceiling rates in order to pass on the increased costs to their customer, United. The same question would be posed if the state court had decreed on the merits that royalties must be calculated on the basis of 78 cents per Mcf or $1.40 cents or some other figure. And, as we have seen, this question must be decided adversely to Pennzoil and Shell.

[357]

Fifth, in requesting special relief to flow through increased royalty costs, even absent the establishing of cost

justification, Pennzoil and Shell are in effect requesting an automatic flow-through of increased royalty costs in the same fashion as, for example, state production taxes. To grant such a request could lead to an avalanche of similar special relief requests and could negate the established area and nationwide rates. Both the Commission and the courts have rightly refused to permit such a result. The Supreme Court in *Mobil, supra* (517 U.S. at 328) has specifically rejected the notion of an automatic flow-through of higher royalty costs. Moreover, if an automatic flow-through of increased royalty costs is permitted, it has not been demonstrated here why a similar flow-through should not be permitted for other costs which are not controlled by the Commission, e.g., the producers' labor and material costs.[10]

Sixth, the dire results envisaged by Pennzoil and Shell from the state court litigation are, of course, speculative. It is highly doubtful that Williams would prevail on its claim that "market value" for basing royalty payments means a price in excess of the Commission-established area and nationwide ceiling prices. While holding that the Commission lacked jurisdiction to regulate the royalty prices paid by producers to lessors, the Court of Appeals in *Mobil Oil Corporation* v. *Federal Power Commission*, (463 F.2d 256 (C.A.D.C., 1972), cert. den. 406 U.S. 976) stated (at 265):

> "Without purporting to rule on the matter in any way, we can certainly visualize the possibility that a court confronted with a contention of entitlement to a market price basis higher than the producer's ceiling would consider it to run counter to the intention of the parties, unless there is something to rebut the fair presumption that they contemplated interstate movement and market prices compatible therewith. The

[10] A dispute over these items could always be framed in terms of a settlement agreement to end litigation.

> court might also consider that this result would be in furtherance of

[358]

> the general principle against application of contracts so as to contravene public policy, whether or not the result would be in violation of supremacy clause doctrine prohibiting state rules or decisions that require a regulated company to take action inconsistent with Federal regulation, see Northern Natural Gas Co. v. State Corp. Comm. of Kansas, 372 U.S. 84, 83 S. Ct. 646, 9 L. Ed. 2d 601 (1963)."

There is nothing in the instant case to "rebut the fair presumption" that Pennzoil, Shell and Williams "contemplated interstate movement and market prices compatible therewith." On the contrary, Pennzoil and Shell entered into their first sales contracts with United (which, of course, was selling the gas in interstate commerce for resale) in the early 1940's and those contracts were periodically renewed, all with at least the knowledge and acquiescence of Williams, into the 1950's (see Ex. 4) and after the Supreme Court's decision in *Phillips Petroleum Company* v. *Wisconsin*, 347 U.S. 672 (1954) established Commission jurisdiction under the Natural Gas Act over producer sales in interstate commerce for resale. Indeed, it was in January 1955, after the *Phillips* decision, that Williams amended the 1952 lease to require royalties based on 1/4 of the market value (Ex. 10).[11]

[11] It would seem that a prime purpose of the market value lease provision is to insure that the lessee will use his best efforts to sell the gas at the highest price he legally can. This cannot exceed the Commission ceiling price when Pennzoil or Shell sell the gas involved here. Even if the leases were cancelled and the acreage reverted to Williams, the gas would still be dedicated to the interstate market and Williams would be bound not to sell at higher than the Commission ceiling (see Section IV, *infra*). It would be anomalous for the Louisiana court to hold that "market value," where neither the producer-lessee nor the lessor himself could lawfully sell the gas at more than the ceiling price, exceeds the ceiling.

Moreover, even if Williams were to prevail on the construction of "market value," it is doubtful that the Louisiana court would decree lease cancellation for underpayment of royalties. For as intervenor, Michigan Wisconsin Pipe Line

[359]

Company, points out in its brief (Initial Brief, p. 9), recent Louisiana cases hold that a failure or delay of royalty payments is justified where there is a legitimate dispute or uncertainty as to the lessee's obligation.[12]

Furthermore, even if the leases were cancelled and the acreage reverted to Williams, the gas would still remain dedicated to the interstate market and could not be diverted therefrom without abandonment authorization granted by the Commission to Williams (see Section IV, *infra*). Failing such abandonment authorization, Williams could not sell the gas at prices in excess of the Commission-established area and nationwide rates. And, contrary to petitioners' assertion, Williams would not be authorized to sell at the small producer rate of 130% of the nationwide rate (Opinion No. 742, Aug. 20, 1975) since gas sales attributable to the leases in question exceed 10,000,000 Mcf a year (Shell's yearly sales were 1,309.4 MMcf (Ex. 10), and Pennzoil's were 25,588,412 Mcf (Tr. 48)).

The foregoing is not to be taken as expressing the view that Pennzoil and Shell would prevail if the state court case were litigated. The issues are not free from doubt and there is some risk[13] they would lose. However, it is also

[12] Pennzoil, Shell and United adduced no expert testimony as to Louisiana law, nor did they brief this matter. A good discussion of Louisiana law on the construction of market value and on lease cancellation is contained in Michigan Wisconsin's brief.

[13] Shell and Pennzoil have not attempted here to measure the risk. The most they would say is that they take the litigation "seriously" and took several months to negotiate the settlement (see, e.g., Tr. 38, 39, 41). Of course, the higher they assess the risks, the greater will be their incentive to implement the Settlement Agreement even if their petitions are denied.

clear they would have a reasonably good chance of prevailing. Special relief here should not be based on the speculative outcome of the state court litigation. And, as noted, in *Fourth, supra,* even if it were finally adjudicated by the

[360]

state courts that the market value basis for royalty payments were 78 cents or $1.40 per Mcf, or some other figure, the same issues would be present here. Pennzoil and Shell would still have to establish on the basis of their own costs and revenues that they could not absorb the higher royalty payments without a price increase. This, Pennzoil has not even attempted to do. And Shell has failed in its attempt.

IV

PETITIONERS HAVE NOT ESTABLISHED THAT ABANDONMENT OF THE ROYALTY INTEREST IN THE GAS IS PERMITTED BY THE PUBLIC CONVENIENCE OR NECESSITY

The instant petitions request, as an alternative if special relief is not granted to flow through increased royalty costs based on 78 cents per Mcf, that the Commission authorize abandonment of one-eighth of the gas under the 1934 lease and one-fourth of the gas under the 1952 lease (i.e., the royalty interests in the leases). This request for abandonment authorization is pursuant to the Settlement Agreement of June 18, 1975 between Pennzoil, Shell and Williams, wherein Williams agreed, in lieu of higher royalty payments, to accept in settlement of the litigation deliveries in kind of the aforementioned shares of the gas "for use or sale by Lessor [Williams] to any market" (Settlement Agreement, Section I.B; Appendix A to Shell's Petition).[14]

[14] United has agreed, upon Commission authorization, to release from its gas purchase contracts with Pennzoil and Shell only ⅛ of the gas (Ex. 7, Tr. 53; Ex. 8, Tr. 56).

Petitioners have a heavy burden of proof to establish that abandonment of gas which has been dedicated to the interstate market is permitted by the public convenience or necessity. Section 7(b), Natural Gas Act,[15] 15 U.S.C., § 717 f (b);

[361]

Michigan Consolidated Gas Company v. *F.P.C.*, 283 F.2d 204, 214 (C.A.D.C. 1960), cert. denied, 364 U.S. 913; ***Transcontinental Gas P.L. Corp.*** v. ***Federal Power Com'n***, 488 F.2d 1325 (C.A.D.C. 1973), cert. denied, 417 U.S. 921; ***Deep South Oil Company of Texas***, 25 F.P.C. 734 (1961).

Petitioners have not satisfied their rigorous burden of proof. The basis for the requested abandonment is Williams' claim to higher royalty payments and the ensuing state court litigation. Petitioners claim that because of the risks of that litigation it is in the public interest to abandon one-eighth and one-quarter of the gas to the intrastate market rather than chance losing all the gas to that market.

Williams, however, has agreed to accept higher royalty payments, computed on the basis of 78 cents per Mcf, in full settlement of its claims in the litigation. We have seen in Section III, *supra*, that Shell can absorb such higher royalty costs without an increase over the area and nationwide rates. Pennzoil did not even attempt to make any showing that it could not absorb such higher royalty costs. Since Pennzoil's costs, revenues and profits attributable to the 1934 lease are peculiarly within its knowledge and it has the burden of proof, its failure to adduce any evidence whatsoever on the issue warrants the inference that

[15] There is no issue here of depletion of reserves. As of January 1, 1975, Shell's and Pennzoil's estimated remaining recoverable reserves in the Gibson Field, of which the Williams leases acreages are a part, were 68.7 Bcf and 86.2 Bcf, respectively (Tr. 48, 58). No data were presented as to the reserves attributable to the Williams leases themselves.

Pennzoil can absorb the higher royalty costs without an increase over the area and nationwide rates. Since both Pennzoil and Shell have the ready means, within their costs and profit margins, of avoiding the risk that the state court might decree cancellation of the leases and possible diversion of the gas from the interstate market, their petitions for abandonment of the royalty owner's share of the gas must be denied.

Wholly apart from the foregoing, their abandonment petitions must be denied. They are based entirely on Williams' unadjudicated claims that it is entitled to higher royalty payments and lease cancellation for underpayment of such royalties. If unadjudicated claims, whether for higher royalties or for any of the other elements which make up the gas producers' costs of production, can serve as the basis for abandonment, then the critical gas shortage in the interstate market will be severely worsened, a result which is surely contrary to the public interest.

[362]

We have shown (Section III, *supra*), that it is at best doubtful whether Williams would prevail in the state court litigation on the market value royalty issue. Even if Williams did prevail on that issue, it is extremely doubtful that the state court would decree cancellation of the leases. But even if such cancellation were ordered, this does not mean that the gas would be diverted from the interstate market. For under the Commission's recent ruling in *El Paso Natural Gas Company, et al.*,[16] (Opinions 737 and 737-A, issued July 11 and September 3, 1975), Williams would be bound to continue selling the gas in the interstate market (see also *Hunt Oil Co.* v. *F.P.C.* 306 F.2d 334, 342 (5th Cir., 1962).

[16] Pending on petition for review *sub nom.*, *Southland Royalty Company* v. *F.P.C.*, 5th Cir., No. 75-3373.

Indeed, *El Paso* is an *a fortiori* case, since, unlike the situation here, there was no question in *El Paso* that the acreage would revert to the lessor (upon expiration of the lease term).

Speculation as to the outcome of unadjudicated royalty claims, and the disire of Pennzoil and Shell to rid themselves of potential damages liability, cannot serve as the basis for meeting the stringent public interest standard of Section 7(b) for abandonment.

Moreover, as has been well stated by the Staff (Initial Brief, p. 9):

> "Nor is abandonment authorized because pending litigation to cancel the leases casts a cloud over further expenditures (Tr. 77). From a practical standpoint, this argument carries little weight, since the Louisiana court has already indicated that the parties could expect to go to trial this fall (Tr. 41). Moreover, the court in *Michigan Consolidated Gas Company* v. *F.P.C.*, 283 F.2d 204 (D.C. Cir. 1960), cert. denied, 364 U.S. 913 (1960),
>
> **[363]**
>
> disposed of this type of self-interest reasoning when it stated that simply because an applicant wants to abandon service 'because it wants to be rid of what it considers to be a vexatious servitude' is not a reason for granting its request (283 F.2d 204, at 214)."

V

THE REQUESTED SURCHARGE FOR PAST ROYALTIES MUST BE DENIED

The instant petitions for special relief request an increase above area and nationwide ceiling rates in order to impose a surcharge for higher royalty payments called

for in the Settlement Agreement of June 18, 1975[17] or gas sales made between January 1, 1974, and the date of a Commission order approving special relief to flow through higher royalty payments on sales made after the date of such an order. This request for a temporary surcharge for royalties on past deliveries must be denied.

In the first place, the Commission in its August 29, 1975, order has denied "[t]hose portions of the petitions relating to temporary surcharges for back royalty payments by Shell and Pennzoil" (Ordering par. (B), at p. 4). This specific surcharge denial was treated separately in the Order from the Commission's denial of the requested special relief for increased royalty payments (Ordering par. (A); see also Commission findings (1) and (2), p. 3). Pennzoil's Application For Rehearing and Reconsideration does not even mention the surcharge issue. And the Commission's order of September 22, 1975, granting the Application, merely vacated "[t]hat portion of the August 29, 1975, order denying Pennzoil's and Shell's petitions for special relief." (Ordering par. (B)).

[364]

Thus, the Commission's August 29, 1975, denial of the requested surcharge was not vacated by its September 22, 1975, order, and the surcharge issue is now foreclosed. While Pennzoil has made a brief reference to the surcharge matter in its initial brief (p. 10), Shell has not briefed it at all.

Secondly, the petitions' requests for price increases to reflect the surcharge for past royalties tracks the June 18, 1975, Settlement Agreement of the parties. No surcharge would be due under that Agreement in the absence of Commission approval. For the higher royalties on 1974 gas

[17] **See Section II B of the Settlement Agreement (Appendix A to Shell's Petition).**

deliveries (which are to be computed on the basis of 45 cents per Mcf) are to be paid by Pennzoil and Shell to Williams "only to the extent the FPC permits Lessees [Pennzoil and Shell] to recover such amounts from United" (Agreement, Sec. II B(a)). Since such a recovery has been denied by the Commission, or is denied by this decision (of course, subject to Commission review), no surcharge would be payable on 1974 deliveries.

As to the surcharge for deliveries made in 1975 and prior to the date of a Commission order herein, the Settlement Agreement provides that the higher royalty payments shall be made to Williams only "(if the Commission approves Section I.A. hereof)."[18] (Agreement Sec. II.B.(b) [parenthesis is in the Agreement].) Since the parties agreed that a surcharge for royalties would be due on deliveries made in 1975 and prior to the date of the Commission's decision, only in the event the Commission grants the special relief request as to future royalties, and since such special relief must be denied for future royalties, the surcharge for past royalties would not be due under the Agreement. Moreover, Section VIII of the Agreement does not reserve to the parties an option to terminate the Agreement for failure of the Commission to approve the surcharge. Apparently in recognition of the

[365]

foregoing, Pennzoil has candidly conceded that "implementation of the settlement is not contingent upon approval of the surcharge" (Initial Brief, p. 10).[19]

[18] Section I.A. of the Settlement Agreement refers to the parties' agreed-upon royalty basis of 78 cents per Mcf and the flow-through of such increased royalty payments to United – treated in Section III, above.

[19] Pennzoil went on to add that nevertheless the surcharge should be approved "as a most reasonable resolution of the claim for alleged past underpayment of royalties" (p. 10).

Thirdly, no justification has been established by Pennzoil or Shell, in terms of their costs, revenues and profits attributable to operations under the Williams leases, which would warrant an increase over area or nationwide rates for imposition of the surcharge against United (see Section III, *supra*).

Finally, wholly apart from the foregoing, and even if the Commission were to approve the special relief request insofar as relating to royalties on future deliveries, the request for a surcharge for royalties on past deliveries must be denied. Petitioners are requesting an increase above area and nationwide ceiling rates in order to impose a surcharge against United for the producers' alleged underpayment of royalties on past deliveries of gas to United. The Commission in the instant proceeding has recognized that there "is no basis for allowing a temporary surcharge for the purpose of permitting a producer to recover retroactive royalty payments." (Order of August 29, 1975, finding (2), p. 3). The surcharge would be a kind of retroactive rate increase, which is forbidden by Section 4 of the Natural Gas Act (*Continental Oil* v. *F.P.C.*, 236 F.2d 839 (5th Cir., 1956), cert. denied, 352 U.S. 996; *Shell Oil Company* v. *F.P.C.*, 334 F.2d 1002 (3rd Cir., 1964)).

[366]

VI

ULTIMATE FINDINGS AND ORDER

Upon consideration of the entire record, including the briefs filed in this proceeding, it is further found and concluded:

(1) Petitioners Pennzoil and Shell are each engaged in the sale of natural gas in interstate commerce for resale and each, is, therefore, a "natural-gas company" within the meaning of the Natural Gas Act.

(2) Pennzoil's and Shell's sales of natural gas attributable to the Williams leases, which are the subject of the petitions herein for special relief and for abandonment, as more fully described hereinabove and in the petitions herein, are made in interstate commerce for resale and are subject to the jurisdiction of the Commission.

(3) Pennzoil has failed to establish that its requested gas price increases above area (Opinion No. 598) and nationwide rates (Opinion No. 699 orders), as more fully described hereinabove and in Pennzoil's petition for special relief, are justified in the public interest, convenience and necessity or that the requested rates are just and reasonable. The aforesaid relief sought by Pennzoil is contrary to the public interest, convenience and necessity and the requested rates are not just and reasonable.

(4) Shell has failed to establish that its requested gas price increases above area (Opinion No. 598) and nationwide rates (Opinion No. 699 orders), as more fully described hereinabove and in Shell's petition for special relief, are justified in the public interest, convenience and necessity or that the requested rates are just and reasonable. The aforesaid relief sought by Shell is contrary to the public interest, convenience and necessity and the requested rates are not just and reasonable.

(5) Pennzoil has failed to establish that its requested surcharge, as more fully described hereinabove and in Pennzoil's petition for special relief, is justified in the public interest, convenience and necessity or that the requested surcharge is just and reasonable. The aforesaid relief sought by Pennzoil is contrary to the public interest, convenience and necessity and the requested surcharge is not just and reasonable and is otherwise prohibited by Section 4 of the Natural Gas Act.

[367]

(6) Shell has failed to establish that its requested surcharge, as more fully described hereinabove and in Shell's petition for special relief, is justified in the public interest, convenience and necessity or that the requested surcharge is just and reasonable. The aforesaid relief sought by Shell is contrary to the public interest, convenience and necessity and the requested surcharge is not just and reasonable and is otherwise prohibited by Section 4 of the Natural Gas Act.

(7) Pennzoil has not established that the available supply of natural gas, which is the subject of its petition herein for abandonment, is depleted to the extent that continuance of service is unwarranted, or that the present or future public convenience or necessity permit such abandonment, as required by Section 7(b) of the Natural Gas Act.

(8) Shell has not established that the available supply of natural gas, which is the subject of its petition herein for abandonment, is depleted to the extent that continuance of service is unwarranted, or that the present or future public convenience or necessity permit such abandonment, as required by Section 7(b) of the Natural Gas Act.

WHEREFORE, IT IS ORDERED, subject to review by the Commission, on appeal or on its own motion, as provided in the Commission's Rules of Practice and Procedure, that the petitions herein of Pennzoil and Shell be, and they are hereby, denied in all respects.

Dated this 19th day of November, 1975.

SAMUEL Z. GORDON
Samuel Z. Gordon
Presiding Administrative Law Judge

[371]

UNITED STATES OF AMERICA
FEDERAL POWER COMMISSION

PENNZOIL PRODUCING COMPANY

Docket No. RI76-8

SHELL OIL COMPANY

Docket No. RI76-10

BRIEF ON EXCEPTIONS

STATEMENT OF THE CASE

In this proceeding, the Commission has been asked to approve either alternative contained in a settlement agreement entered into by Pennzoil Producing Company (Pennzoil) and Shell Oil Company (Shell) with Williams, Inc. (Williams), one of their lessors, arising out of pending market value royalty litigation in a Louisiana state court. Two leases executed by Williams — one in 1934 and one in 1952 — are involved in the litigation. Shell and Pennzoil sell gas produced from the Gibson Field, Terrebonne Parish, Louisiana to United Gas Pipe Line Company (United) under their FPC Rate Schedules Nos. 202 and 234 respectively. The gas sold to United is produced from both Williams leases as well as from leases executed by other lessors.

Williams has demanded royalty payments based upon prices substantially in excess of the ceiling rates prescribed by the Commission for these sales, and has declared the leases terminated for the failure of Pennzoil and Shell to pay the amount of royalties demanded. Shell and Pennzoil have asked a Louisiana state court to issue an injunction

and declare that Shell and Pennzoil are paying the correct royalties. By reconventional demand (counterclaim) Williams has asked the Court to declare the leases terminated and to assess damages for the alleged underpayment of royalties.

As a result of extensive negotiations, Pennzoil, Shell and Williams reached a settlement agreement which, if implemented by the Commission, would resolve this litigation. Among other provisions of this settlement, Pennzoil and Shell agreed to seek Commission authorization to collect increased rates from United to reflect increased royalty payments based upon negotiated rates substantially less than the rates demanded by Williams as market value, or, in the alternative, in the event that authorization for increased rates is denied, to seek authorization to abandon the sale of the royalty portion of the gas. United, expressing its agreement with the settlement, consented to amend its gas purchase contracts to provide

[372]

for the increased rates or to release the royalty portion of the gas, depending on the alternative approved by the Commission.

Pursuant to the settlement, Pennzoil filed in Docket No. RI76-8 and Shell filed in Docket No. RI76-10 petitions seeking Commission approval of the increased rates to reflect the higher royalty payments demanded by Williams, or alternatively, the petitions requested Commission approval to abandon the royalty interest portions of the gas. On August 29, 1975, the Commission, finding that "there is no justification for allowing a producer to pass through higher royalty costs to the consumer without a showing that Petitioner's overall costs are higher than those reflected in Opinion 699-H", (Order, p. 3) denied requests by Pennzoil and Shell for rate increases. Further,

the Commission consolidated the dockets and scheduled a hearing for September 23, 1975, on the applications to abandon the royalty portions of the gas.

The Commission, however, on September 22, 1975, issued an order granting the Application For Rehearing filed by Pennzoil and vacating that portion of the order of August 29, 1975, which denied the requests for special rate relief. Upon its own motion the Commission applied their ruling to Shell. On this date the Commission also granted interventions of various petitioners, including United.

A hearing was held on September 23, 1975, at which time Shell, Pennzoil and United adduced testimony of witnesses and presented documentary evidence. In his decision issued November 24, 1974, the Presiding Administrative Law Judge, Samuel Z. Gordon, concluded that both Pennzoil and Shell failed to establish that their requested gas price increases above the Commission's prescribed rates are justified in the public interest, convenience and necessity or that the requested rates are just and reasonable. He further concluded that the requested surcharge for past royalties is not justified in the public interest, convenience and necessity or just and reasonable and that the abandonment of the royalty portions of the gas is not permitted by the present or future public convenience and necessity.

SUMMARY OF UNITED'S BASIC POSITION

United intervened in the proceeding on the basis of letter agreements it executed with Pennzoil and Shell in which it agreed, subject to Commission approval, to give effect to the settlement agreement reached between Pennzoil, Shell and Williams. United considers the issues presented by the pending market value royalty litigation as serious ones. If Williams

[373]

is successful in terminating the leases, United and its customers could lose all the gas United is currently purchasing from the acreage covered by the Williams leases. It therefore appeared to be in the best interests of United and its customers to execute the letter agreements with Pennzoil and Shell.

United believes that the settlement is reasonable and in the public interest and that these criteria, rather than a producer cost standard, should be utilized by the Commission in adjudging the requests of Pennzoil and Shell. United prefers the increased rate alternative because United and its customers would retain all the gas from the acreage covered by the Williams' leases at only slightly higher prices. This assumes, of course, United's right to reflect the increased prices in its jurisdictional rates. However, if the Commission denies this alternative, United prefers the abandonment of the royalty portion of the gas rather than face the uncertain outcome of the state court litigation and its possible adverse results.

EXCEPTIONS

Point I. The Presiding Judge erred in holding that the price increases contained in the settlement agreement are not justified in the public interest, convenience and necessity and are not just and reasonable.

Point II. The Presiding Judge erred in holding that the present or future public convenience and necessity does not permit approval of the abandonment of that portion of the gas attributable to the royalty owner's interests.

ARGUMENT IN SUPPORT OF EXCEPTIONS

The Commission is cognizant of the problems presented by market value royalty claims which could result in the

payment of royalties based upon some rate other than those prescribed by the Commission. In response to *Texas Oil & Gas* v. *Vela,* 429 S.W.2d 866 (Tex. 1968), and *J. M. Huber Corp.* v. *Denman,* 367 F.2d 104 (5th Cir. 1966), the Commission, attempting to control the maximum amount to be paid royalty owners under jurisdictional sales, held in Opinion 562, issued July 32, 1969, that it had jurisdiction over royalty interest owners. The Commission's determination was subsequently reversed in *Mobil Oil Corporation* v. *FPC,* 462 F.2d 256 (D.C. Cir. 1972), *cert. denied,* 406 U.S. 976 (1972). The Court held that the royalty provision of a lease does not constitute a sale of gas for resale and thus the amount a royalty owner receives for his royalty share of gas sold in interstate commerce is not subject to the jurisdiction of the Commission.

[374]

Recently the problem has grown more acute because of the growing disparity between prices applicable to intrastate contracts and Commission prescribed rates applicable to interstate contracts. This proceeding is not an isolated case before the Commission. There are currently several related market value royalty proceedings pending before the Commission. (e.g. *Roy M. Huffington, Inc.,* Docket No. CI75-602, *Exxon Corp.,* Docket No. RI76-29). The Commission must attempt to resolve the issues presented by market value royalty claims to insure a solution which will be in the public interest, by maintaining the continuous supply of gas to the interstate market at reasonable prices. In this proceeding the parties have settled their litigation after extensive negotiation. This settlement is now before the Commission for approval. It offers a reasonable, certain and practical resolution of complex issues and should be approved in the public interest.

POINT I

The Presiding Judge erred in holding that the price increases contained in the settlement agreement are not justified in the public interest, convenience and necessity and are not just and reasonable.

The Presiding Judge held that the increased rates provided for in the settlement must be denied because Pennzoil and Shell had not proved ". . . that their overall costs with the increased royalty payments will be greater than the ceiling rates or that their out-of-pocket expenditures will exceed revenues." (Initial Decision, p. 15) Whether Pennzoil and Shell have or have not made such a showing is beside the point. The public interest cannot be so narrow or limited as the cost experience of an individual producer or an individual project. The public interest is concerned with certainty of gas supply and maintaining the continuous supply to the interstate market at reasonable prices. The settlement before the Commission must be assessed in terms of its reasonableness and the public interest in that it removes the risks and unpredictability associated with the pending litigation. The settlement would remove these risks at a slightly higher price to the consumer which is justified in light of the advantages to be gained.

The increase rate alternative of the settlement agreement is in the public interest because it will provide:

1. *Certainty* of gas supply. If the increased rate alternative of the settlement is approved by the Commission, the state court litigation will be resolved, and the risk that the leases could be terminated and the gas lost to United and the interstate market would be eliminated. It is unreasonable to rely on Opinion No. 737 (in which the

[375]

Commission indicated that gas once dedicated to the interstate market remains dedicated after lease termination) as negating this risk altogether. Opinion No. 737 is currently on appeal, *sub. nom., Southland Royalty Co.* v. *FPC* (5th Cir. 75-2851), and its outcome is uncertain. In view of the uncertainty surrounding the outcome of the litigation, the only way to insure the retention of all the gas produced from the acreage covered by the Williams leases is to grant the requests for rate increases. The risk of lease termination and possible diversion of all of the gas from interstate commerce is unacceptable to United. As United's witness, D. L. Smith, Senior Vice President-Gas Supply, testified, "United is in deep curtailment and cannot stand to lose one foot of gas." (Tr. 62).

2. *Additional Supply.* If the settlement is approved Pennzoil and Shell can go forward with the work they have projected for the Williams leases to bring forth additional supply. Pennzoil's witness testified that the uncertainty of the litigation would cause Pennzoil to defer indefinitely plans for a development well and a workover of an existing well, both of which would add additional supply. (Tr. 30). Shell's witness testified that the lessor's demands had caused Shell to postpone drilling a well that had been planned. (Tr. 78-79).

3. *Reasonableness of price.* The 78 cent settlement price* upon which the increased royalty is to be computed is reasonable and is less than the record evidence of contract prices for non-jurisdictional gas purchases in Southern

* The present effective rates will not be increased to 78 cents. They will be increased only by the difference between royalty computed on a rate of 78 cents and royalty computed on the present effective rates. This difference will not accrue to the benefit of Pennzoil and Shell but will be flowed through to Williams.

Louisiana. United's witness listed ten such contracts United has with various producers under which the prices ranged from \$1.08 — \$1.58. (Tr. 64). Further, the consumer would pay less for this gas under the increased rate alternative than if the case were litigated, the leases terminated, and Williams continued to sell the gas to United. The Presiding Judge is incorrect in asserting that Williams would not be authorized to collect the small producer rate. (Initial Decision, p. 22). The Presiding Judge made this assertion under the apparent belief that Williams' volumes would be in excess of 10,000,000 Mcf per year. However, the volumes attributed to Pennzoil's sales cited by the Presiding Judge are field-wide volumes of which the volumes produced from the Williams leases are only a part. Further, even if Williams were in excess of 10,000,000 Mcf, Williams would be

[376]

entitled to collect the small producer rate for the first 10,000,000 Mcf sold subsequent to lease termination, as Williams is currently making no jurisdictional sales. Section 157.40 of the Commission's Rules and Regulations. The small producer rate pursuant to Opinion No. 742 would be 130% of the national rate for new gas which would be 68 cents, not including adjustments. This is a substantially higher rate than those requested by Pennzoil and Shell in this proceeding.

POINT II

The Presiding Judge erred in holding that the present or future public convenience and necessity does not permit approval of the abandonment requests.

Section 7(b) of the Natural Gas Act provides that abandonment is appropriate if permitted by the public convenience and necessity. United does not disagree with the

Presiding Judge's statement that, "Petitioners have a heavy burden of proof to establish that abandonment of gas which has been dedicated to the interstate market is permitted by the public convenience and necessity." (Initial Decision, p. 23). The natural gas shortage which presently faces the nation requires that all efforts be made to maintain and secure gas supplies for the interstate market for the benefit of gas consumers.

United clearly prefers Commission approval of the requests for increased rates to reflect the increase in royalties. However, if this alternative is denied, and United is faced with the risk of lease termination and the possible loss of all the gas produced from the Williams leases, Commission approval of the requests to abandon the royalty portions of the gas would insure that United and its customers retain the major portion of the gas that which is attributable to the working interests. Elimination of this risk has to be consistent with the public convenience and necessity.

CONCLUSION

Approval of the increased royalty alternative of the settlement agreement is in the public interest. It will not only assure that the production from the Williams leases will continue to be committed to United and the interstate market, but it will also enable Pennzoil and Shell to proceed with their development plans for these leases. Further, these two advantages will be made available to the consumer at rates

[377]

only slightly higher than are currently being paid. The settlement before the Commission for approval is a reasonable one, and represents an effort to resolve the market

value royalty issue in a manner consistent with the best interests of the parties, United and its customers.

Respectfully submitted,

WILLIAM B. CASSIN
Group Vice President and
General Counsel

PHILLIP D. ENDOM
Vice President and
Associate General
Counsel

W. O. CRAIN, JR.
LEE M. HUBER
700 Milam, P. O. Box 1478
Houston, Texas 77001

DONALD R. ARNETT
1223 Chamber of
Commerce Bldg.
Houston, Texas 77002

By LEE M. HUBER
Lee M. Huber

Attorneys for United Gas
Pipe Line Company

December 19, 1975
Houston, Texas

[384]

UNITED STATES OF AMERICA BEFORE THE FEDERAL POWER COMMISSION

PENNZOIL PRODUCING COMPANY
Docket No. RI76-8
SHELL OIL COMPANY
Docket No. RI76-10

Brief on Exceptions of
Pennzoil Producing Company

Pennzoil Producing Company, pursuant to Section 1.31 of the Commission's Rules of Practice and Procedure, respectfully submits herewith its Brief on Exceptions to the Initial Decision of the Administrative Law Judge, issued in this proceeding on November 24, 1975.

I.
STATEMENT OF THE CASE

This proceeding involves a settlement of a complex case and is a direct result of litigation in a Louisiana state court in which Williams Inc. (Williams) has asserted market value royalty claims against Pennzoil Producing Company (Producing) and Shell Oil Company (Shell).[1] While the parties have reached an agreement which will settle the litigation, implementation of that settlement is dependent upon affirmative Commission action in this proceeding. Without question, the resolution of the litigation, whether by way of settlement or by way of trial, will have a substantial impact on gas consumers. Thus, since this Commission is charged with protecting the interests of gas consumers, it is incumbent upon the Commission to insure that

[1] *Shell Oil Company and Pennzoil Producing Company* v. *Williams Inc., et al.,* Civil District Court for Orleans Parish, Louisiana, Docket No. 573-591.

[385]

the litigation is resolved in the manner most consistent with those interests. Consequently, the ultimate issue that must be resolved in this case is whether it is in the best interest of interstate gas consumers to allow settlement of the state court litigation.

The litigation involves gas sold by Producing in interstate commerce from the Gibson Field, Terrebonne Parish, Louisiana. The Gibson Field acreage is covered by a 1934 lease from Williams to Shell Oil Company. Producing obtained its interest in the acreage as a result of a 1942 sublease from Shell. The royalty which Producing (lessee) must pay to Williams (lessor) is governed by section 4 of the 1934 lease, which provides in pertinent part as follows:

> "Lessee agrees as to royalties: . . . to pay Lessor for gas/or casinghead gas . . . one-eighth ($\frac{1}{8}$) of the value thereof, calculated at the market rate prevailing at the well . . . ." (Exhibit 9, at 3.)

Producing is selling the gas covered by the 1934 lease to United Gas Pipe Line Company (United) in interstate commerce for resale under Producing's Rate Schedule No. 234. Thus, under Section 1(b) of the Natural Gas Act the price Producing may collect from United is subject to the jurisdiction of the Commission, and the Commission has established maximum rates which are applicable to this sale. A portion of the gas is covered by Opinion No. 598 (Southern Louisiana Area Rate) and the rest is covered by Opinion No. 699-H (national rate for new gas). Producing is collecting the highest just and reasonable price allowed under these opinions. (Tr. 24) Producing is paying royalty to Williams based on these prices, *i.e.,* for old gas one-eighth of the Opinion No. 598 rate and for new gas one-eighth of the Opinion 699-H rate.

Williams, however, claims that the "market rate" for the gas is in excess of that which the Commission has determined to be the highest just and reasonable rate which Producing may collect. Williams therefore demanded payment of royalties based on such higher rates and declared the lease terminated for Producing's alleged failure to pay royalty based on the prices Williams claimed to be the "market rate." (Tr. 24; Exhibits 1-3) Litigation has resulted in which Producing has asked a Louisiana State Court to issue an injunction preventing lease termination and declare that Producing is paying the correct royalty. Williams has asked the Court to declare the lease terminated as of June 5, 1974, and to assess damages (1) in excess of $3,000,000 for alleged underpayment of royalties through

[386]

April 30, 1975, plus (2) an amount equal to the value of all minerals produced since June 5, 1974, plus (3) other damages and attorneys' fees. Williams' claim as to the "market value" upon which the royalty allegedly should be paid has escalated steadily from 70¢ per Mcf for the period November, 1973, through May, 1974, to $1.40 per Mcf for the period January, 1975, through April, 1975. (Tr. 24-25; Exhibits 4-6)

As a result of intensive negotiations, Producing and Williams have reached a settlement which, if implemented, will resolve the litigation and remove all of the uncertainties as to the status of the lease and the amount of the royalties thereunder. Implementation, however, is contingent upon Commission approval of either of two alternatives in Producing's application in this docket. The first alternative involves a rate increase, all of which would flow through to Williams in the form of increased royalties based on the higher of 78¢ (plus 1.5¢ per Mcf annual escalations beginning January 1, 1976) or 150% of the highest

national or area rate permitted. The second alternative involves abandonment by Producing of the sale of the royalty share of the gas (1/8) so that Williams may take that royalty share in kind for use or sale by Williams to any market. Under this alternative, Producing will continue to sell the remaining seven-eights of the gas to United at the prices currently in effect.[2]

The settlement also provides that Williams' claim for past underpayment of royalties for the period October 1, 1971 through 1973 will be dropped. Thus payment for increased past royalties would be limited to the period January 1, 1974 through June 30, 1975, and the royalty amount would be based on 45¢ per Mcf for volumes delivered in 1974 and 85¢ per Mcf, including the 7¢ per Mcf Louisiana severance tax, for deliveries during the first six months of 1975. A surcharge would be added for twelve months to the price Producing receives from United in an amount sufficient to make up the difference between this increased royalty obligation and the amount already paid. Again this entire amount would flow through to Williams so that Producing would retain none of the increase. At the end of twelve months the surcharge would terminate and the price would decrease accordingly. Implementation of the settlement is not dependent upon Commission approval of the surcharge request.

[387]

Pursuant to the settlement agreement, Producing filed its application for individualized rate relief in the form of the excess market value royalty flow through or, in the alternative, abandonment, on July 1, 1975. The Commission initially set the abandonment alternative of the appli-

---

[2] The price would, of course, change in accordance with Commission rules and regulations and the terms of Producing's contract with United, just as it would absent the Williams litigation.

cation for hearing, but rejected the individualized rate relief alternative on the ground that a showing of overall costs in excess of those reflected in Opinion 699-H was required. (Order issued Aug. 29, 1975). On rehearing, however, the Commission reversed the prior summary rejection of the individualized rate relief application, and set that request for hearing along with the alternative abandonment proposal. (Order issued Sept. 22, 1975).

The hearing was held on September 23, 1975. In the initial decision issued on November 24, 1975, the Administrative Law Judge denied the relief Producing seeks in this proceeding.

II.

PRODUCING'S POSITION

The starting point for evaluating Producing's price increase request is that the prices Producing was collecting for gas sold from the Williams acreage were just and reasonable prior to Williams' market value royalty demands. No one has disputed this, and indeed no one can since those prices were the applicable ceiling prices that the Commission has already deemed to be just and reasonable. Also indisputable is that both the courts and the Commission have recognized that increases above the applicable ceiling rates are sometimes just and reasonable. Thus the questions to be resolved are (1) whether a price increase is justified under the circumstances of this case and, if so, (2) whether the increase Producing proposes is just and reasonable.

Two fundamental principles have been established for determining whether a price increase above the ceiling rate is appropriate. First, the ceiling price is inappropriate if out of pocket expenses exceed revenues, and therefore an increase is justified under such circumstances. Second, if

the ceiling price is *otherwise* inappropriate an increase is also justified.

Producing does not here claim that the ceiling prices are inappropriate because out of pocket expenses exceed revenues and, quite naturally, Producing has not attempted to establish what it does not claim. Producing does assert, however, that the unique circumstances of this

[388]

case establish that the current ceiling price is otherwise inappropriate. Basically, the price is inappropriate because continuation of that price creates unacceptable risks to gas consumers, while the price increase removes those risks entirely.

The question, then, becomes whether the particular increase which Producing proposes in order to accomplish this objective is just and reasonable. On this question, two considerations are controlling. First, the price increase must not excessively increase Producing's profits since, under the current state of the law, even if the price increase is in the best interest of consumers it may nonetheless be unreasonable if it creates "excessive" profits. Second, the price increase must be a reasonable cost to be borne by consumers in order to avoid the risks associated with the current price. Stated differently, considering all of the circumstances of the litigation, the question is whether the settlement agreement is a reasonable resolution of the litigation from the point of view of gas consumers.

The evidence establishes that a price increase is essential in order to avoid the risks to gas consumers associated with the litigation. The evidence also establishes that the increase proposed by Producing will not create one cent of profit for Producing and that the unacceptable risks of the litigation will be avoided at minimal cost. Under these

circumstances the public interest demands that the price increase and surcharge be approved. In the alternative, the public interest requires that the abandonment application be approved.

III.
THE JUDGE ERRED IN REFUSING TO ADOPT THE SETTLEMENT AND DENYING THE REQUESTED RELIEF

A. The Judge Erred in Determining That Project Cost Evidence Is Required to Establish The Propriety Of The Individualized Rate Relief Request.

B. The Judge Erred In Determining That Producing's Evidence Is Not Sufficient To Establish The Need For Individualized Relief.

C. The Judge Erred In Determining That Producing's Evidence Is Not Sufficient To Establish The Need For Abandonment.

D. The Judge Erred In Denying The Surcharge Request.

[389]

IV.
ARGUMENT

A. The Judge Erred In Determining That Project Cost Evidence Is Required To Establish The Propriety Of The Individualized Rate Relief.

All of the reasons set forth by the Judge in rejecting the individualized rate relief portion of Producing's application are dependent upon a single basic premise. The Judge's basic premise was that, no matter what the circumstances, a price increase in excess of the applicable ceiling price can only be justified by project cost evidence. Since Producing did not present project cost evidence, the Judge concluded

that Producing's price increase request must necessarily be rejected, regardless of whether compelling public interest considerations would otherwise justify the increase. If in fact such a result is required, it would indeed be an anomalous one. Examination of the authorities upon which the Judge relied, however, reveals that the Judge's basic premise was erroneous and therefore his conclusion was also in error.

First, the Judge relied on the Commission's discussion in Opinion No. 699 dealing with special relief from the national rate. Initial Decision at 11-12. To be sure, that opinion does establish that special relief will be granted when a producer can demonstrate that out-of-pocket expenses exceed revenues from sale at the national rate or when a producer can meet the requirements of Order Nos. 455, 481, or 482. But Opinion No. 699 does not establish that those are the only circumstances under which special relief is appropriate. To the contrary, the Commission specifically stated that it was not "... attempting to enumerate all circumstances which would form an adequate basis for granting special relief. . . ." *Id.* at 105. This approach to special relief, *i.e.*, an express recognition that there might be circumstances other than costs in excess of ceiling prices that will justify rate relief in excess of ceiling prices, had its genesis in the very first area rate opinion, *Permian Basin Area Rate Proceeding* 34 FPC 225-6 (1965), *aff'd* 390 U.S. 747 (1968) and has been carried through in every area or national rate decision since. *See MacDonald* v. *FPC,* 505 F.2d 355, 358 (D.C. Cir. 1974).

Likewise, neither the Supreme Court's consideration of the market value royalty problem in the context of reviewing the Southern Louisiana Area Rate Order[3] nor the Fifth

[3] Opinion No. 598.

[390]

Circuit discussion of the same problem in the same context supports the Judge's conclusion.[4] In *Placid Oil Company* v. *FPC,* 483 F.2d 880, 911 (5th Cir. 1973), the Court recognized the potential problem that market value royalties created, and stated that a producer faced with such a problem is entitled to seek individualized relief. As the Commission had done in Opinion No. 699 with respect to special relief in general, the court did not purport to enumerate all of the circumstances under which the individualized relief would be appropriate. Rather, the Court pointed out that relief would be available whenever market value royalty costs rendered the Opinion 598 rates "confiscatory or *otherwise inappropriate.*" *Id.* at 911. (Emphasis added).

In affirming the Fifth Circuit's opinion, the Supreme Court likewise recognized the potential market value royalty problems. The Court did not even address the circumstances under which relief from such problems would be appropriate. What the Court did do, however, was hold that ". . . an affected producer is entitled to seek individualized relief." *Mobil Oil Corp.* v. *FPC,* 417 U.S. 283, 328 (1974).

Thus, far from supporting the Judge's basic premise that special relief must necessarily always be supported by project costs, the cases upon which the Judge relied for that determination establish the antithesis of that position. First, in discussing special relief generally the Commission has repeatedly recognized that it was not foreclosing special relief based on circumstances other than those enumerated. Furthermore, the courts have held that market value royalty costs in particular can be a basis for individualized relief, not only when they render ceiling prices con-

[4] Discussed in the Initial Decision at 14.

fiscatory, but also under any other circumstances which cause the ceiling price to be inappropriate. Individualizd relief from ceiling prices which are not confiscatory but are "otherwise inappropriate" is precisely what Producing seeks in this case.

Nor are cases such as *Consumers Union of United States* v. *FPC,*[5] and *MacDonald* v. *FPC,*[6] which establish the need for cost data to support Commission approved rates, in any way inconsistent with Producing's position. Producing does not contend that the proposed price increase in this case can be supported without cost evidence. To the contrary, Producing has introduced cost evidence[6a] (Exhibit 13). Thus the issue is not whether cost evidence is required, but rather the type of cost evidence that is required. And in resolving that issue, the controlling consideration is the purpose which cost evidence serves. If Producing's cost evidence satisfies that purpose, then most certainly it is sufficient.

[391]

The *MacDonald* case and *Cities of Fulton* v. *FPC,* 512 F.2d 947 (D.C. Cir. 1975) are especially instructive on this point. In *MacDonald,* the Commission had approved a settlement which provided for special relief in return for an increased drilling commitment on the producer's part. While the Court reversed this decision on the basis that there was inadequate cost evidence, the Court went to great lengths to point out the function of cost evidence in order to establish the reason that the cost evidence was inadequate in that case. The Court pointed out that protection of the consumer from *profiteering* was the primary purpose of the Natural Gas Act.[7] As a result, the Court found

[5] 510 F.2d 656 (D.C. Cir. 1974).

[6] 505 F.2d 355 (D.C. Cir.).

[6a] Discussed *infra* at 19-20.

[7] 505 F.2d 363.

that cost evidence must be sufficient to allow determination of the justness and reasonableness of the "new profit expectations resulting from the special relief."[8] Quoting from *City of Chicago* v. *FPC,* 458 F.2d 731, 751 (D.C. Cir. 1971), *cert. denied* 405 U.S. 1074 (1972), the Court concluded that:

> " '[W]hen the inquiry is whether a given rate is just and reasonable to the consumer, the underlying concern is whether it is *low* enough so that exploitation by the producer is prevented.' " *MacDonald* v. *FPC, supra* at 364. (emphasis in original).

The function of cost evidence was again examined in *Cities of Fulton* v. *FPC, supra.* In that case the Commission had approved an application under which a producing subsidiary of a pipeline proposed to sell to the pipeline at area rates gas produced from leases acquired by the pipeline prior to October 7, 1969 and subsequently transferred to the subsidiary.[9] The Commission had traditionally priced such pipeline production on a cost of service rather than an area rate basis.[10] However, the Commission allowed the higher area rate basis in that case because the producing subsidiary agreed to plow back into exploration and development the difference between the revenue received under area rate treatment and that which would have been received under cost of service treatment.

[392]

In reviewing the Commission's approval of area rate treatment, the *Cities of Fulton* Court was first concerned with whether the cost evidence was sufficient. As in *MacDonald,* the Court considered the function of cost evidence in order to make this determination. The Court observed

[8] 505 F.2d 365.

[9] *Panhandle Eastern Pipe Line Company, et al,* Docket No. CP71-237,*et al,* Opinion Nos. 626 and 626-A (1972).

[10] ***Pipeline Production Area Rate Proceeding,*** **Docket No. RP66-24 (Phase II) (Order Issued June 14, 1972).**

that the cost evidence in *MacDonald* had been deemed insufficient because it did not establish that the special relief price would not yield 'excessive profit returns'."[11] Evaluating the cost evidence on that basis, the Court concluded that is was sufficient since it established (1) the amount of the increased profits so as to allow a determination that they were not excessive and (2) that under the unique circumstances of that case the benefits to gas consumers justified a price (area rates) in excess of what otherwise would have been appropriate (cost of service).

The need to tailor the cost evidence requirement to the purpose served by such evidence has also recently been expressly recognized by the Commission in *American Petrofina Company of Texas (Operator) et al.,* Docket Nos. RI75-17 and RI75-19 (Order Issued March 3, 1975). In that case, the producer sought an increase above the applicable ceiling rate that was being collected in order to cover the costs of additional compression. As in all price increase cases, the Commission was concerned with the sufficiency of the cost evidence. But the Commission did not assess the sufficiency of that evidence with blinders on. Rather, the Commission considered the unique circumstances of the case in making that assessment. In so doing the Commission determined that an assessment of the propriety of a price increase above the applicable ceiling price designed to reflect exact and measurable incremental costs does not require an inquiry into overall costs:

> "Because American Petrofina is currently charging the applicable area ceiling rate, its rate is just and reasonable *without inquiry into its actual total costs of production.* An increase in a just and reasonable rate to reflect the *exact incremental cost per Mcf* of compression expenses should not, of itself, deprive that rate of its just and reasonable character." *Id.* at 4. (Emphasis added).

[11] ***Cities of Fulton, supra*** **at 365.**

The cost inquiry was therefore limited to the costs and revenues associated with the price increase. On that basis, the Commission concluded that the price increase was justified because it would not increase the producer's profits and

[393]

because it was a reasonable price to pay for the benefits achieved.[12]

In sum, while it is clear that cost evidence is required in this case, it is equally clear that project cost evidence or evidence establishing that the current price is confiscatory is not required. Rather, the evidence must establish first that, for whatever reason, the current price is inappropriate. In addition, the evidence must establish that the price increase which Producing proposes (1) does not excessively increase Producing's profits and (2) is a reasonable price for consumers to pay in order to eliminate the circumstances which render the current price inappropriate. On all counts, the evidence presented by Producing in this case establishes that the increase is just and reasonable.

B. The Judge Erred In Concluding That The Evidence Does Not Establish That The Rate Increase Is Just And Reasonable.

The Judge's erroneous determination that project cost type evidence is a prerequisite to the individualized relief Producing seeks precluded consideration of the sufficiency

[12] For similar Commission action see Barnwell, Inc., Docket No. CI72-654 (issued August 2, 1973); Petro-Lewis Corp., Docket No. RI74-43 (issued January 10, 1974); Texas Pacific Oil Co., Inc., Docket No. RI74-49 (issued January 10, 1974); Mapco Inc., Docket No. RI74-129 (issued February 7, 1974); T. L. Nutt, Docket No. RI74-78 (issued March 18, 1974); Suburban Propane Corp., Docket No. RI74-111 (issued April 4, 1974); KWB Oil Property Management, Inc., Docket No. RI74-194 (issued April 7, 1975); HNG Oil Co., (Operator) *et al.*, Docket No. RI75-7, (issued April 22, 1975).

of the evidence based on the proper standard. As a result, even though the Judge recognized that the arguments set forth by Producing and Shell as to the propriety of the settlement agreement "have certain attractions,"[13] the Judge nonetheless felt constrained to reject the rate increase application. The evidence reveals that Producing's application does indeed have certain attractions, and when that evidence is measured by the appropriate standard the propriety of the rate increase is clear.

[394]

1. The Risks Of The Williams Litigation To Gas Consumers Render The Current Price Inappropriate.

The price Producing is currently collecting for gas sold from the Williams acreage is currently inappropriate for one reason and one reason only. Williams' market value royalty claims create significant and unacceptable risks to gas consumers. If the price is increased, those risks will be eliminated by way of settlement of the litigation.

The risks are present because both of the legal issues which underlie Producing's application in this case are unresolved. The first unresolved issue is the outcome of the Williams litigation. The second unresolved issue involves the impact that an adverse resolution will have on gas consumers.

a. The risks of the litigation.

In discussing the risks associated with Williams' market value royalty claims, Producing certainly does not intend to establish that Williams' position will ultimately prevail if the matter is litigated. Indeed, Producing's position in the lawsuit is that Producing has been and is paying the

[13] Initial Decision at 10.

proper royalty and that lease termination is inappropriate. But for purposes of this proceeding, the critical fact is that the outcome of the litigation is unpredictable.

The market value royalty problem had its genesis in cases such as *Texas Oil and Gas* v. *Vela,* 429 S.W.2d 866 (Tex. 1966) and *J. M. Huber Corp.* v. *Denman,* 367 F.2d 104 (5th Cir. 1966). In those cases, the courts determined the market value royalty provisions there involved did not contemplate that the royalty would be based on the price actually received by the producer-lessee for the sale of gas produced from the acreage covered by the lease, nor even that the royalty was to be based on the market value for gas produced from the leased acreage at the time the contract under which the gas was being sold was entered. Rather, the courts determined that the royalty was to be based on the market value for the gas at the time the gas is delivered. Thus, for cases covered by the *Vela-Huber* rule, the royalty basis constantly fluctuates as the market value of gas fluctuates.

While this result certainly created an unfavorable situation for some lessee-producers, standing alone it does

[395]

not create the substantial problems under the Natural Gas Act which underlie Producing's application in this case. Such problems are generated by the combination of the *Vela-Huber* rule with the decision in *Mobil Oil Corp.* v. *FPC,* 463 F.2d 256 (D.C. Cir. 1971), *cert. denied* 406 U.S. 976 (1972). There, the court held that the royalty provision of a lease does not constitute a sale of gas for resale and thus the amount a royalty owner receives for his royalty share of gas sold in interstate commerce is not subject to the jurisdiction of the Commission. Lessors such as Williams contend that since they are not subject to the juris-

diction of the Commission, the "market value" upon which their royalty is based is not limited by the Commission's ceiling prices. While Producing believes that considerations other than those resolved in *Mobil* require a determination that the market value of gas sold in interstate commerce can not exceed applicable ceiling rates, the critical fact is that a genuine dispute as to this issue exists. And as the disparity between FPC ceiling rates and unregulated intrastate rates continues to grow, Williams' claims for increased royalties also increase.

Moreover, the problem is further exacerbated in Louisiana. For in Louisiana underpayment of royalties may be a basis for lease termination. Again, whether that result would ultimately obtain in the Williams' litigation is quite obviously unknowable at this time, and is in fact totally irrelevant. What is relevant is that lease termination is a serious possibility.

In discussing the possibility of an adverse resolution of the litigation, the Judge expressed his view that Producing and Shell will prevail. Producing certainly shares his view. But the Judge presented only one side of the argument. In so doing, the Judge relied heavily on the brief of intervenor Michigan Wisconsin Pipeline Company. Yet the Judge failed to note that, despite its exposition of the law favoring Producing's position in the litigation, Michigan Wisconsin *does not* oppose Producing's application as a reasonable basis upon which to resolve the litigation.[14]

Michigan-Wisconsin's lack of opposition to the settlement must, of course, be based on its recognition that there are, in fact, two sides to this issue. Producing has not and does not intend to present the lessor's view of the issue, for determining which side will prevail is not a part of this case. Suffice it to say that at least one

[14] Michigan-Wisconsin Initial Brief at 1, 4, 12.

[396]

jurisdictional natural gas company is in fact making "market value" payments pursuant to a settlement agreement,[15] and that others view the problem as serious enough to warrant the institution of proceedings before this Commission.[16] It is therefore not surprising that the Judge, despite his assessment of the merits of the litigation, concluded that the issue is not free from doubt and that some risk of an adverse resolution is present. Nor is it surprising that Producing and its purchaser, United, have independently concluded that the litigation is a serious matter. (Tr. 39, 48). And it is this risk of an adverse resolution, not a subjective determination as to the ultimate outcome of the litigation, which is critical to this case.

b. The risks of an adverse resolution of the litigation.

The risk of adverse resolution is therefore a real one and it carries with it obvious ominous implications for interstate gas consumers. If Williams were to prevail and the lease were terminated, Williams would then have total control, to the exclusion of Producing, of the gas produced from the acreage now covered by the lease. Whether Williams could then sell in the intrastate market the gas which Producing is currently selling interstate is an open question. In the *Southland Royalty* case[17] the Commission indicated that gas dedicated to the interstate market remains dedicated after lease termination. But that determination is being vigorously contested on appeal,[18] and the ultimate

[15] El Paso Natural Gas Company, Docket No. RP74-22, *et al.* (Order Issued Nov. 29, 1974), *reh'g denied* (Jan. 29, 1975).

[16] Roy M. Huffington, Docket No. CI75-602; Exxon Corp., Docket No. CI75-602.

[17] *El Paso Natural Gas Company,* Opinion No. 737, Docket No. CP75-209 (July 11, 1975), *reh'g denied,* Opinion No. 737-A (September 3, 1975).

[18] Appeal pending *sub nom., Southland Royalty Co.* v. *FPC* (5th Cir. 75-2851).

appellate resolution is necessarily uncertain. In fact, in reaching its conclusion on this question the Commission found it necessary to overrule prior Commission precedent bearing on

[397]

the issue,[19] a clear indication that the question is indeed a close one. Thus, without question, the possibility of termination of the Williams lease carries with it a substantial risk that the gas Producing currently sells to the interstate market will be diverted to the intrastate market. This risk is totally unacceptable during this time of critical interstate gas shortage, and it is one that United is not willing to bear or subject its customers to. (Tr. 48-49)

Moreover, even if the *Southland Royalty* case is ultimately affirmed and Williams cannot divert the gas to the intrastate market, risk of substantial adverse impact on natural gas consumers would still be associated with lease termination. The risk under these circumstances would be the distinct possibility of a substantial price increase for the gas sold from the Williams lease acreage. Producing is currently selling some of the gas at Opinion No. 598 rates and some at Opinion No. 699-H rates, with an average price per Mcf of about 40.91 cents, exclusive of Btu adjustment and tax reimbursement.[20] If the lease were terminated and the gas sales contract between United and Producing therefore also terminated, Williams would presumably be able to sell all of the gas to United as a small pro-

[19] In *El Paso* v. *Bass,* Opinion No. 638, 48 FPC 1269 (1972), the Commission held that one who holds an overriding royalty with an option to "back in" to a working interest at pay out may, upon exercise of the option and without obtaining abandonment authorization, sell the gas attributable to the working interest to a purchaser other than the purchaser who had previously purchased all of the gas. The *Bass* case was overruled in Opinion No. 737-A, at 3.

[20] Late-filed Exhibit 13 at 2.

ducer under a replacement contract at 130% of the national rate for new gas. See Federal Power Commission Rules and Regulations, Section 2.56(a)(2)(iii); Opinion No. 742, Docket No. R-393 (August 28, 1975). The price per Mcf then would be 68 cents not including adjustments (130% of 52 cents), about 27 cents per Mcf more than Producing is currently collecting.

The Judge dismissed this risk by concluding Williams would not qualify as a small producer because the sales attributable to the Williams acreage exceed 10,000,000 Mcf per year.[21] In determining whether a producer qualifies

[398]

as a small producer, however, the test is not the amount of gas the producer will sell in the future. The test is the amount the producer sold in the year preceding the application. Commission Rules and Regulations Section 157.40(b)(1)(i). Since Williams is currently making no jurisdictional sales, Williams would qualify for a small producer certificate. Furthermore, when a small producer exceeds the 10,000,000 Mcf limit after obtaining a small producer certificate, sales made under contracts executed prior to the reporting date for the year in which the 10,000,000 Mcf limit was exceeded still qualify for small producer treatment. Commission Rules and Regulations Section 157.40(d); *E. G. Rodman,* Docket No. CS66-50 (Order issued Aug. 27, 1974). Therefore, even if the gas sold by Williams during the first year exceeded 10,000,000 Mcf, and Williams' small producer certificate were subsequently terminated as of the reporting date for that year, Williams would still receive the small producer price for those sales since they would be made under contracts executed prior to the termination date. Hence, if the lease were terminated but the gas remained dedicated to the

[21] Initial Decision at 22.

interstate market, the price would increase about 27 cents per Mcf above Producing's current average price for the same gas.

Furthermore, the risks to gas consumers of an adverse resolution of the market value issue even if not accompanied by lease termination are substantial. If Producing were forced to pay royalties on the basis of $1.40, and allowed to pass this cost on, the increase per Mcf would be about 12.5 cents.[22] Whether this cost could be passed on would be dependent upon a determination of the proper treatment of market value royalty costs.

As with the other issues in this case which create the risks the settlement is designed to eliminate, an academic resolution of this issue is not a part of this case. Rather, the critical fact is that the issue exists and creates the possibility that the price will increase substantially more if the settlement is not implemented than if it is. Yet the Judge dismissed this risk by concluding that the issue has already been resolved and that market value royalty costs can only be passed on when they render the ceiling price confiscatory.[23]

In fact no such determination has been made. A number of proceedings currently before the Commission reveal that the proper treatment of market value royalty costs is a

[399]

very live issue and is a far reaching and complex question involving considerations far different than those pertinent to special relief based on cost factors other than market value royalty costs.

[22] The current royalty cost is one-eighth of about 40.9¢ or about 5 cents. The one-eighth royalty based on $1.40 would be about 17.5 cents.

[23] Initial Decision at 23.

The extent of the problem is illustrated by the variety of contexts in which it has recently been raised before the Commission. In addition to this proceeding, the case of *Roy M. Huffington*, Docket No. CI75-602 also involves a Louisiana producer faced with market value royalty claims based on alleged "market values" in excess of applicable ceiling prices.[24] The problem is not limited to Louisiana producers, however, as shown by Exxon's declaratory order petition in Docket No. RI76-29, which was prompted by market value royalty claims in Texas. Nor is the problem limited only to producers, as is exemplified by the current proceeding in which a pipeline, El Paso Natural Gas Company, has been authorized to increase its rates, subject to refund, to reflect increased overriding royalties based on "market value" payments being made pursuant to a settlement agreement.[25]

The mere pendency of these cases reveals the extent of the problem. The action the Commission has taken in response to these applications reveals that the problem can not be solved simply by reference to precedent involving special relief based on costs other than market value

[24] The problem has also surfaced in a number of producer certificate proceedings in which the Commission has authorized sales of gas pursuant to contracts under whch the purchasers will reimburse the producers for all or some of the amount by which market value royalty lease provisions require the producers to pay royalty in excess of that which would be paid if based on the Commission regulated rates received under the contracts. The Commission has reserved the right to suspend any increase based on these provisions. *Amoco Producing Company, et al.*, Docket No. G-7490, *et al.* (Order issued October 15, 1975); *Texaco Oil Inc., et al.*, Docket No. CI65-407, *et al.* (Order issued October 3, 1975) (Amoco, Marathon and Superior); *Ashland Oil Co., et al.*, Docket No. G-3913, *et al.* (Order issued April 17, 1975) (Amoco); *Exxon Corporation*, Docket No. CI75-263 (Order issued December 30, 1974).

[25] *El Paso Natural Gas Company*, Docket No. RP74-22, *et al*, (Order Issued Nov. 29, 1974), *reh'g denied* (Jan. 29, 1975).

royalty costs. Thus, for example, in the *Huffington* case, the

[400]

Commission has directed that one of the issues to be considered is "the proper treatment of market value royalty costs."[26] If special relief precedent were controlling, there would be no issue as to the proper treatment of market value royalties. Thus the Commission has clearly recognized that market value royalties involve considerations far different than those pertinent to the ordinary special relief case.

The Judge, however, did not consider these differences. For example, in response to Producing's argument that market value royalties will put in Williams' pocket revenue which would otherwise be available for exploration and development, the Judge reasoned that any cost in excess of those used in computing ceiling rates will have the same effect and ceiling rates already take account of this effect. While it may be true that this adverse effect has been considered in establishing most cost components of the ceiling rate, it has not been provided for in the royalty cost component. In computing all cost components except royalties, the Commission considered actual costs, high and low, and reached an average. But in computing the royalty cost average, the Commission did not consider royalties based on prices in excess of the ceiling price and thus market value royalty costs are not taken account of in ceiling prices.

Moreover, it is inherently unreasonable for one governmental agency (the FPC) to allow a price utilizing a price component based on one figure, while another governmental agency (state court) requires actual payment of that

[26] Order Issued July 21, 1975 at 5.

same cost component based on a higher figure. The only other cost component in which this would occur if an actual average were used is the state production and severance tax. And in recognition of the unique nature of such costs, the Commission has always treated state severance taxes as an add on, the amount of which varies as state laws vary.

Finally, one other consideration that distinguishes market value royalty costs from other costs is that it is a flow through item. It is not an operating cost in that it is not incurred until the gas is sold and remuneration received, at which point the revenue is passed directly to the lessor. Again, the only other cost of which this is true is the state severance tax. As already noted, the Commission has recognized the uniqueness of a cost of this nature by its unique treatment of state severance taxes.

Thus it is clear that the circumstances surrounding market value royalty costs are different from those pertinent

[401]

to all other costs except state severance taxes and that those circumstances must be carefully considered in resolving the proper rate treatment of market value royalty costs. The existence of this issue is important to this case because it shows that Producing's application can not be rejected simply by reference to special relief precedent not involving market value royalty costs and because it shows that the just and reasonable price for gas sold from the Williams acreage may ultimately be far in excess of that proposed in the settlement if the settlement is not implemented. At the same time, the resolution of the proper treatment of market value royalty costs is not a part of this case. To the contrary, the very purpose of the settlement agreement and the application based thereon is to dispose of the Williams litigation in a manner satisfactory

to both the litigants and gas consumers without the need to run the risks attendant to an ultimate resolution of the underlying issues involved.

Finally, even if it is ultimately determined that market value royalty costs can not be passed on, adverse resolution of the litigation would have an adverse impact on the consumer. The indisputable fact is that under those circumstances — royalty based on $1.40 but no price increase — funds that would otherwise be available to Producing for exploration and development would instead be funneled into the lessor's hands. As stated by Producing's witness Gray, that result would not benefit anyone except Williams and would do so to the ultimate detriment of gas consumers through a reduction in the capital available for exploration and development. (Tr. 26)

Indeed, Producing's future plan for development of the very acreage which is the subject of this case represents an example of this type of impact. Producing currently plans to drill one development well and to recomplete an existing well during 1976. It is estimated that the development well would produce approximately 1.65 Bcf of gas and, after workover, the recompleted well will produce about 2.42 Bcf. (Tr. 30). Yet, if forced to pay royalty based on $1.40, Producing will defer these development plans indefinitely (Tr. 31).

In sum, at the current price, gas consumers face substantial risks. While the ultimate impact on gas consumers if the Williams case is litigated and resolved adversely to Producing cannot be precisely predicted, two things are quite clear. First, gas consumers can only lose in the event of such an adverse determination. Second, if the lease is terminated, the impact is likely to be devastating. Since these risks can not be avoided so long as the

[402]

current price is in effect, but can be totally avoided by the proposed price increase, the current price is inappropriate.

2. **The Amount Of The Price Increase Is Just And Reasonable.**

Since the current price is inappropriate, the ultimate question in this case is whether Producing's cost evidence is sufficient to establish that the amount of the price increase which Producing proposes in order to remedy the currently inappropriate price is just and reasonable. As established in *Cities of Fulton* and *American Petrofina,* the factors that are pertinent in making this determination are (1) whether the price increase will generate excess profits and (2) whether the increase is a reasonable price for consumers to pay in order to eliminate the risks which render the current price inappropriate.

On the first point there can be no dispute. Since Producing is currently collecting the applicable ceiling rates, no inquiry into the actual total costs of production is necessary. *American Petrofina, supra.* Thus the only question is whether the increase will generate revenues which will exceed the costs which form the basis for the increase. On this question, the evidence in this case is even clearer than that deemed to be sufficient in *American Petrofina.* In *American Petrofina* there was initially some question as to whether the additional compression which was the basis for the increase would generate profits from the production of additional liquids. Here, there is absolutely no way that the increase will generate any profit for Producing. Every cent of the increase will flow directly through to Williams. There could be no clearer case of lack of excessive profits than this one.

Similarly, the cost evidence clearly establishes that the amount of the increase is more than reasonable in order to avoid the risks associated with the Williams litigation. Producing is currently collecting an average of 40.91¢ per Mcf for gas sold from the Williams acreage. If the flow through alternative is approved, Producing will collect 44.55¢ per Mcf.[27] Thus for a price increase of about 3.64¢ per Mcf, none of which inures to Producing's benefit, the consumer avoids the substantial risks of an adverse resolution of the lawsuit, which are:

[403]

(1) Diversion of all of the gas from the interstate market so that the interstate consumer cannot obtain it at any price.

(2) A price increase of at least 27¢ per Mcf if Williams sells the gas in interstate commerce at the small producer national rate.

(3) Either a price increase far in excess of 3.6¢ per Mcf if the lease is not terminated but royalty payments must be based on $1.40, or diversion to the lessor of substantial amounts of capital otherwise available for exploration and development.

Whether 3.6¢ per Mcf is a reasonable price to pay to avoid these possible results is certainly a matter of judgment, but that judgment must be based on the record. Producing, Shell, and United all presented testimony that the price increase is reasonable and necessary to end the Williams litigation. At the same time, not a single one of United's customers, who will ultimately pay the price increase contemplated by Producing's application or bear the burden of an adverse resolution of the underlying legal issues, has expressed the slightest opposition to Producing's application. The amount of the increase is reasonable and the public interest demands that it be approved.

[27] Late-filed Exhibit 13.

C. The Judge Erred In Rejecting The Abandonment Request.

Producing, as well as Shell and United, views the individualized relief in the form of the royalty flow through as the preferable method for alleviating the problems inherent in the Williams litigation (Tr. 27, 49, 82). In order to place before the Commission all possible means for dealing with the problem, Producing and Shell have also proposed abandonment of the royalty share of the gas as an alternative to the royalty flow through. Under this proposal, Williams would take the royalty share of the gas in kind in settlement of the litigation, thereby eliminating the risk of that litigation.

Under Section 7(b) of the Natural Gas Act, abandonment is appropriate so long as the public convenience and necessity permits. Producing has no quarrel with the Judge's determination that this burden is a heavy one.[28] *Michigan Consolidated Gas Company* v. *FPC*, 283 F.2d 204

[404]

(D.C.Cir. 1960), *cert. denied* 364 U.S. 913 (1960). Indeed, in view of the critical nationwide gas shortage, the need to prevent the diversion of gas dedicated to the interstate market is of the highest priority in protecting gas consumers' interests. And that is precisely why abandonment of the royalty share of the gas is appropriate in this case.

If the choice here were between losing one-eighth of the gas and losing none of the gas there would quite obviously be no issue. But that is not the case. The choice is between losing one-eighth of the gas and risking the loss of all of the gas. If loss of one-eighth of the gas is cause for concern, as it most certainly is, then that concern is increased eight-fold when the possibility of losing all of the gas is considered.

[28] Initial Decision at 23, 24.

Thus, under the unique circumstances of this case, the proposed abandonment actually insures the retention of more gas for the interstate market than would rejection of the abandonment. The Judge nonetheless rejected the abandonment proposal. The Judge first observed that the litigation can be settled pursuant to the terms of the settlement agreement even without Commission approval of Producing's application in this proceeding. In fact, the settlement agreement can not be implemented without Commission approval of the application filed pursuant to that agreement. Producing can not and will not agree to a settlement of the litigation on the basis of the present settlement agreement without Commission approval of such application. Moreover, if the Commission does not act so as to allow implementation of the settlement, Williams is no longer bound to its terms. Despite the Judge's conclusion to the contrary,[29] there is not a shred of evidence that even suggests that, if Williams were released from its binding obligation by the Commission's failure to approve Producing's application, Williams would still be willing to settle on the terms contained in the present agreement. The choice therefore is between Commission action which will allow implementation of this settlement agreement and the risks of litigation.

The Judge also concluded, in essence, that unadjudicated claims can never be the basis for abandonment.[30] The Judge cited no authority for this proposition and in fact there is none. To the contrary, an inflexible rule of this nature is directly contrary to the flexible standard of public convenience and necessity set forth under Section 7(b), and the public interest would certainly be disserved by application of a rule which would not allow consideration of the

[29] Initial Decision at 19, 24.

[30] Initial Decision at 24.

factors surrounding the settlement which effect the public interest.

[405]

In addition, a settlement can be the basis for a price increase so long as its terms are reasonable. *El Paso Natural Gas Company, supra.* There is no basis for allowing price relief based on a settlement, but not allowing abandonment based on a settlement when the public interest would be best served by such action.

The Judge also determined that the risk of diversion of the gas from the interstate market is not a significant one. As noted earlier, however, the possibility of loss of the gas is a very real one. El Paso has assessed the risks of market value claims as serious enough to warrant settlement.[31] And the ultimate outcome of the *Southland Royalty* case is very much in doubt.

Thus there is a risk that all of the gas will be diverted from the interstate market, and in fact the Judge did not conclude that there was no such risk. Yet the Judge at no point balanced that risk against the abandonment proposal to determine whether elimination of the risk is more consistent with the public interest than assumption of that risk. Again, this is a matter of judgment. But the judgment of the party with the most direct interest should be entitled to significant weight. In this proceeding that party is United. United's witness Smith, giving due weight to United's already difficult supply situation, testified that, on balance, the risk of losing all of the gas is unacceptable to United and its customers. (Tr. 49)

Finally, the Judge concluded that Producing's abandonment application is based on "self-interest reasoning."[32]

Nothing could be further from the truth. Certainly Producing believes that it will be in a more favorable position if the litigation is settled than if it is not. But that is not the basis for Producing's application. The basis for the application is that the consumer will also be better served by settlement. Surely, that the public interest coincides with Producing's interest is no reason for ignoring the public interest. If the royalty flow through is not allowed, abandonment is in the public interest and should be approved.

D. The Judge Erred In Rejecting The Surcharge Request.

The Judge rejected Producing's surcharge request without considering whether the surcharge is reasonable under the facts of this case. The Judge felt constrained to reject the surcharge without considering the merits because

[406]

(1) the Judge determined that the Commission had already rejected the request in its Order setting the case for hearing, (2) implementation of the settlement is not dependent upon approval of the surcharge, and (3) the Judge viewed the surcharge as a retroactive rate increase. None of these reasons is a valid ground for rejecting the surcharge.

Although the Commission did not specifically refer to the surcharge in setting the price increase request for hearing, certainly all matters relating to the price increase were encompassed by that order. Of course, the surcharge is an integral part of the price increase request. Therefore, while the Commission in its August 29 Order did originally reject the surcharge request, that rejection was necessarily reversed in the Commission's September 22 Order granting rehearing.

Moreover, contrary to the Judge's characterization, the surcharge is not a retroactive rate increase. Rather, it is

prospective adjustment of current prices as part of an overall agreement to eliminate the circumstances which render those current prices inappropriate. As such, it is no different than the surcharge the Commission has allowed El Paso to collect in *El Paso Natural Gas Company*, Docket Nos. RP74-22, *et al.* That surcharge is also a prospective adjustment based on a settlement of market value claims relating to past production. While the propriety of the El Paso surcharge has not been finally resolved, if that surcharge were invalid as a matter of law, as it would be under the Judge's view, then the Commission would have rejected the surcharge rather than allowing its collection subject to refund. Consequently, it is clear that the Judge has misapprehended the nature of the surcharge request and his rejection of the request based on that misapprehension is error.

Finally, whether implementation of the settlement agreement is dependent upon approval of the surcharge request is irrelevant in assessing the propriety of that request. The question is whether the portion of the price increase based on the surcharge is just and reasonable. The surcharge was an integral part of the negotiations leading to the settlement and represents a most reasonable resolution of Williams' claim for alleged past underpayment of royalties. Williams dropped entirely his claim relating to production from October 1971 through December 1973. In addition, as to the remaining claim, the price upon which the royalty is to be based is substantially lower than Williams' alleged market value prices. As a result, the amount of the surcharge is much lower than would be the increase per Mcf if the

[407]

litigation were resolved adversely to Producing and the damages relating to the alleged past underpayments were then passed on.

V.

CONCLUSION

However viewed, market value royalty claims present a difficult problem for both gas consumers and producers. The problem will only become worse however, if it is ignored. It is a practical problem and demands a practical response.

Producing's application provides just such a practical response to the problem as presented by Williams' market value claims. To be sure, that solution will result in a price increase. But that price increase is a fully satisfactory solution to the problem because it eliminates at minimal cost the unacceptable risks to gas consumers inherent in Williams' claims, while at the same time insuring that Producing's profit will not increase a single penny. It is therefore totally consistent with every possible public interest consideration pertinent to this case. The public interest therefore requires approval of the royalty flow through so that

the settlement can be implemented. In the alternative, the abandonment application should be approved.

Respectfully submitted,
Stephen M. Hackerman

A. DUNCAN GRAY, JR.
Vice President and
General Attorney

DIANE BARBER
Pennzoil Producing
Company
900 Southwest Tower
Houston, Texas 77002

JERON STEVENS
STEPHEN M. HACKERMAN
3000 One Shell Plaza
Houston, Texas 77002

BRUCE F. KIELY
Suite 300
1701 Pennsylvania
Ave., N.W.
Washington, D.C. 20006

BAKER & BOTTS
3000 One Shell Plaza
Houston, Texas 77002

Attorneys for
Pennzoil Producing Company

[410]

UNITED STATES OF AMERICA
FEDERAL POWER COMMISSION

PENNZOIL PRODUCING COMPANY
Docket No. RI76-8
SHELL OIL COMPANY
Docket No. RI76-10

BRIEF ON EXCEPTIONS
OF
SHELL OIL COMPANY

Pursuant to Section 1.31 of the Commission's Rules of Practice and Procedure (18 C.F.R. 1.31), Shell Oil Company ("Shell") files its Brief setting out its Exceptions to the Initial Decision of the Presiding Administrative Law Judge issued November 24, 1975, and detailing its reasons in support of those Exceptions.

I.

STATEMENT OF THE CASE

Judge Gordon has accurately set out these specific facts of this proceeding at pages 1 through 6 of his Initial Decision. But he has completely ignored the long procedural background of the "market value royalty problem" discussed at pages 4 through 7 of our Initial Brief, and the fact that this case, together with the *Huffington* (*Roy M. Huffington, Inc.*, Docket No. CI75-602) and *Exxon* (*Exxon Corporation,* Docket No. RI76-29) cases, will be the first opportunity for this Commission to consider one of the major problems which the gas producing industry faces today. Therefore, Shell wishes to supplement the "facts" considered by Judge Gordon with a broader scope of "facts" which we believe the Commission should take into account in reaching its decision here.

We should emphasize at the outset that the relief which Shell seeks, either in permitting the "flow-through" of the additional revenue to be paid the lessor under the settlement, or the abandonment of the lessor's share of the

[411]

gas, will not result in *any* additional revenue to Shell. It will only prevent the occurrence of a "squeeze" on Shell as the lessee-producer, between the rising level of the lessor's royalty demands and the immovable ceiling of the Commission's just and reasonable rate on an area or national basis. Unlike other expenditures made in exploration or production operations, the royalty "cost" in question here could not possibly have been anticipated by Shell. When the first lease was signed in 1934 the Natural Gas Act had not even been passed. When the second lease was signed in 1952, no one, including the Federal Power Commission, believed that its jurisdiction extended over producers at all. Therefore, the royalty provision for a percentage of the "market rate" represented nothing more than an obligation on the lessee to use due diligence to sell the gas from this lease at prevailing market prices. After the first *Phillips* decision[1], there was still no indication that the imposition of Commission regulation on gas producers might result in a different price being permitted for the lessee's share of the gas production than for the lessor's share. It was not until September 20, 1966 when *Huber Corporation* v. *Denman*, 367 F.2d 104 (5th Cir. 1966) and *Weymouth* v. *Colorado Interstate Gas Co.*, 367 F.2d 84 (5th Cir. 1966) were decided that the first indication appeared that the Courts might consider that the lessor was not bound by the Commission's ceiling rates. The Commission attempted to remedy the situation by its Opinion No. 562, *William Harvey Denman, Trustee, et al.* v. *Huber Corporation*, Docket No. RI67-113, 42 F.P.C.

[1] *Phillips Petroleum Co.* v. *Wisconsin*, 347 U.S. 672 (1954).

164, in which it found that it had jurisdiction over the royalty owner's interest in the gas stream. Shell participated actively in the case and supported the imposition that Commission jurisdiction in situations where the lessor sought to receive a different price for his gas than that permitted to be received by the lessee. The Commission's Opinion was reversed by the District of Columbia Circuit in *Mobil Oil Corporation* v. *F.P.C.*, 463 F.2d 256 (1971), by an opinion holding that the Commission had no jurisdiction over the royalty owner's interest in the gas. The District of Columbia Circuit's opinion leaves unanswered several questions which are critical in this case,

[412]

such as whether the lessee can utilize the Commission's ceiling rate as a defense in an action against him by the lessor, and whether the lessor's freedom from jurisdiction will hold as to interest which he acquires by reversion or lease cancellation, after the gas is already moving in interstate commerce.

Finally, the market value royalty question was raised by Mobil Oil Corporation in the *Southern Louisiana Area Rate Proceeding*. In that case Mobil pointed out that the Commission's continued reliance on cost-based rates was resulting in ceiling prices which were less than the market value of the gas being sold, and that as this differential increased the producers' vulnerability to the type of lawsuit involved here increase dramatically. Mobil urged the Commission to consider such royalty demands on an area basis, and make adjustments to the ceiling rate in situations where the royalty owner was able to sustain such demands, through an automatic procedure similar to that utilized by the Commission for increases in state production or severance taxes. The Commission rejected that approach as largely "theoretical" at that time, stating that the producers

would be entitled to file individualized applications for special relief should such royalty owners' demands become a reality. In the case here, the demands *are* a reality, and the Commission is considering in this case, and in the *Exxon* and *Huffington* cases, petitions for special relief, which it told the Fifth Circuit and the Supreme Court were the proper way to handle this problem. The Fifth Circuit clearly set out the parameters which the Commission should follow:

> "If, as subsequent events develop, the producers are put in a bind by their royalty obligations, they may certainly petition FPC for individualized relief. *Permian* contemplated it. FPC has on occasion given it. E. G., Op: 649, 'Opinion and Order Granting Special Relief and Terminating Proceedings" (February 21, 1973). And we find it to be far preferable to speculative prophesies of future royalty components. If the royalty obligations are such as to
>
> **[413]**
>
> make the rates established by Op: 598, and approved by us here, confiscatory or otherwise inappropriate, those producers who are materially affected will certainly have recourse to the administrative process. And, as with the moratoria provisions, if FPC determines that future events substantially change the rate structure for the industry as a whole, it may make appropriate changes." (*Placid Oil Co.* v. *F.P.C.,* 483 F.2d at 911)

This language was also quoted in part by the Supreme Court in affirming the Fifth Circuit's decision in *Mobil Oil Corp.* v. *F.P.C.,* 417 U.S. 283, 328 (1974).

Thus, the Commission is not writing on a completely clean slate in this proceeding. It is dealing with a situation which developed through a series of court decisions which could not possibly have been anticipated by the producer at

the time the lease contracts in question were created. It is dealing with a situation which will not result in any increase in revenue to Shell, even if the relief requested is granted. It is dealing with a problem with which it has refused to cope on an area or a national basis, leaving it to individualized applications for special relief.[2] Thus, to deny Shell relief unless it can successfully pursue the phantom of "overall costs", is to effectively refuse to cope with the market value royalty problem. The inevitable result of such a position by the Commission will be a dissipation of industry resources in litigation, the creation of legal clouds of uncertainty over lessee's titles which will preclude additional development operations on these leases, and a reduced supply of gas to the consumer. Judge Gordon's Opinion completely refuses to consider this basic problem, and therefore, must be rejected by the Commission.

II.

SUMMARY OF SHELL'S POSITION

Shell joined in the Comments of "Indicated Producer Respondents" in the National Rate For New Gas Cases, Docket

[414]

No. RM75-14, filed on May 30, 1975, which advocated a provision in the Commission's national ceiling rate for new gas providing for an automatic adjustment of the national ceiling rate for excess market value royalty costs where incurred by the producer. Shell believes that this method

[2] The scope of the market value royalty issue is emphasized by the Notice published in the Federal Register on November 21, 1975 (Fed. Reg. Vol. 40, No. 226, 54268-70), by the U.S. Geological Survey, advising that it intends to fix the value for royalty purposes on onshore Federal and Indian leases at market value, even though this value may exceed the FPC ceiling price at which the gas is being sold.

of dealing with the market value royalty problem is greatly preferable to the "special relief" approach. We believe that this proceeding proves that the special relief approach promulgated by the Commission in the *Southern Louisiana* decision is unworkable, and provides no effective relief for the producer, and restricts and reduces the gas supply to the consumer and will ultimately result in an increase in the consumer costs for the gas stream. Judge Gordon's Initial Decision assumes that "overall costs" are a concrete figure readily ascertainable by Shell and that Shell is negligent in not filing these costs with the Commission. This assumption is completely contrary to fact. As previous Commission decisions have held, these costs are incapable of precise determination, and may vary from a deficit to large profits, depending solely on the methods selected by the cost estimator. To grant or deny "special relief" based on such showing, is to effectively state that special relief procedures are a snare and a delusion and have no practical effect on the industry.

III.

ARGUMENT

A. There Is No Statutory Or Court-Imposed Requirement That A Producer Must Prove That His "Overall" Costs Are Higher Than The Commission's National Or Area Ceiling Rates Or That His Out-of-Pocket Expenses Will Exceed Revenues Before Obtaining Special Relief.

At page 10 of his Decision, Judge Gordon states "the law is clear" that "a producer seeking special relief from area or nationwide prices based on asserted increased costs must establish that his "overall costs incurred in the operation of the particular well or group of wells are higher than the applicable Commission-established area or nationwide ceiling rates, or, even more stringently, that his out-of-pocket expenses will exceed revenues." We do not

[415]

believe that Judge Gordon has properly interpreted the cases which he cited. On the contrary, in *Mobil Oil Corp.* v. *F.P.C.*, 417 U.S. 283, 41 L.Ed.2d 72, the Supreme Court stated:

> "Mobil's argument assumes that there is only one just and reasonable rate possible for each vintage of gas, and that this rate must be based entirely on some concept of cost plus a reasonable rate of return. We rejected this argument in Permian Basin and we reject it again here. The Commission explicitly based its additional 'non-cost' incentives on the evidence of a need for increased supplies. Obviously a price sufficient to maintain a producer, while not itself necessarily required by the Act (n. omitted), may not be sufficient also to encourage an increase in production." (41 L.Ed.2d at 99-100)
>
> Similarly, in *Permian*[3], the Court said:
>
> "A price is thus just and reasonable within the meaning of § § 4(a) and 5(a) not merely because it is 'somebody's idea of return on a "rate-base,"' (n. omitted) but because it results in satisfactory programs of exploration, development and production." (390 U.S. at 796)

Similarly, in *California* v. *F.P.C.*, 466 F.2d 974 (9th Cir. 1972), the Court rejected an attack on the Commission's area ceiling rate in the Hugoton-Anadarko Area because of the fact that it rested in part on non-cost factors, see 466 F.2d at 989.

It is true, as the Administrative Law Judge states at page 11, that special relief proceedings were limited under the Commission's *Permian Basin* Decision to situations where producers could prove that out-of-pocket expenses were greater than revenues. This policy resulted in no special

---

3 *Permian Basin Area Rate Cases*, 390 U.S. 747 (1968).

[416]

relief applications being granted, as long as it was adhered to by the Commission. By the time the Commission's requirement could be met, the lessee-producer's oil and gas lease was no longer producing in paying quantities, and therefore, he had no reason to seek special relief because he no longer had any lease or production to protect. It was obvious to the producing industry that the Commission had no intention of granting special relief petitions, and so none were filed. Only in recent years, when the Commission has softened this requirement to permit exceptions, has the special relief procedure been utilized at all.

Furthermore, this procedure has not been required for all cost components. In Opinion Nos. 699 and 699-H, the Commission specifically recognized that producers might pay Federal income taxes, and if they paid such taxes, they could file petitions for special relief and receive exceptions from the national ceiling rate, without proving that their other costs were not less than the national average and thus would offset the increase. This finding was specifically affirmed by the Fifth Circuit in *Shell Oil Co. v. F.P.C.*, 520 F.2d 1061, 1080-81 (1975). Furthermore, in all of the area rate decisions, the Commission permitted the producers to collect increases in state production or severance taxes, without any showing of "overall costs" or a showing that producers' costs were not less than the national average. In fact, the entire theory of industry-wide average costs precludes the approach suggested by Judge Gordon's Opinion. If the particular well or set of wells (the size of the project is only one of the unanswered questions) has other exploration and production costs which are above the national average, the addition of the market value royalty clause will clearly place such a producer in a position where he should receive special relief, under Judge

Gordon's Opinion. If on the other hand, the producer's cost for the projects are less than the national average, Judge Gordon's Decision would deny him any additional consideration for market value royalty expense. This is contrary to the approach utilized in the area and national proceedings, as it rewards the high-cost producer and penalizes the efficient producer. The avoidance of this result was one of the primary reasons for the adoption of the area and national ceiling rates in the first place, see *Permian*, 34 F.P.C. at 179.

[417]

B. Denial Of Special Relief In The Absence Of Evidence Of "Overall Costs", Without Defining How Those Costs Are To Be Determined, Or Setting Out Any Of The Parameters By Which Such Determination Is To Be Made, Effectively Eliminates The Special Relief Procedure.

Judge Gordon expresses astonishment that Shell does not know its "overall costs" for the Williams Leases. What is really astonishing is the complete failure of Judge Gordon's Opinion or the Staff's position to come to grips with the problems of the nebulous or non-existent standards for determining these costs. Here are only a few of the questions which must be answered before Shell can have any real knowledge of what figure the Staff or the Judge seek, in asking for "overall costs."

1. The size of the unit involved. We would request the Commission to turn to Exhibit 11, which is a map of the Gibson Field. The two Williams Leases are indicated by the areas colored in red and blue. There is one well located on the 1952 Lease (the area colored in blue). There are ten (10) joint operating units within which all or parts of the Williams Leases are included (see the curved lines on the map). What dollar costs are called for? Are they the costs only of the well

located on the 1952 Lease? Or they the costs of all of the wells in the Gibson Field which are located on any unit which includes any portion of the Williams Leases? There are thirteen (13) wells in the Gibson Field which are included in such units. How many of these wells are to be included in the calculation of joint costs? One of the cases relied on by the Administrative Law Judge, *Macdonald* v. *F.P.C.*, 505 F.2d 355 (D.C. Cir. 1974), apparently required the submission of company-wide cost data, on the theory that the producer might be able to stand a loss on these particular properties if it was making a profit on other properties under the Commission's national and area ceiling rates. The

[418]

only thing that is made certain by Judge Gordon's Opinion is that, in his view, nationwide costs can*not* be used, as this is what Shell attempted to do.

2. Which of the various methods of estimating costs should be utilized? In its area and national rate decisions, the Commission has utilized at least four separate and distinct methods of estimating unit costs. In *Permian I*, the Commission utilized two separate methods of estimating costs for "old" and "new" gas. In Opinion No. 699-H, the Commission adopted still a third method, utilizing the discounted cash flow method. In recent cost studies submitted in Docket No. RM75-14 by the Bureau of Natural Gas and the Bureau of Economics, additional new methods are suggested to the Commission. The wells drilled in the Gibson Field, in which the Williams Leases participate, were drilled over a time period of some thirty-five (35) years. Which of the various cost methods should be utilized for the different wells involved? How are lease acquisition costs, unsuccessful well costs, and geological and geophysical expenses to be allocated? None of these questions are answered by any decision cited by Judge Gordon, or by the Staff, or by the Judge in his Initial Decision. Indeed when queried on the meaning of "overall costs" demanded in this proceeding, the Com-

mission Staff counsel could only say that the "unit cost of gas based on the actual cost associated with the properties involved" (Tr. 116) was required.

3. Assuming the size of the unit and the costing method could be determined, which are obviously impossible under the current Commission rules, all of the difficult problems of allocation of joint costs between liquid hydrocarbons and natural gas remain. Wells in the Gibson Field produce crude oil and liquefiable hydrocarbons. How are the joint costs of wells producing both oil and gas to be allocated? Is the relative cost method to be utilized? Is the liquid credit method to be utilized? Is the sales realization method to be utilized? If so, what value should be attributed to the respective quantities of oil and gas?

[419]

4. There is yet another dimension of the costing problem in addition to the foregoing questions. This is the question of the denominator to be utilized in the unit cost estimate. Is the denominator production of gas on the daily, monthly, or yearly basis? Or is the denominator the amount of reserves added by each well? Or the denominator the amount of reserves remaining in the Gibson Field? Or is the denominator the amount of reserves attributable to the Williams Leases?

Until the Commission determines the ground rules to be followed, and answers some of the questions listed above, the ability of any producer to meet the requirement of justifying his application for special relief by "overall costs" is not difficult — it is impossible. The only practical answer is that any cost study filed by the producer is wrong, if it indicates a result which is above the Commission's ceiling rate. If this is the result which the Commission intends, then it should clearly and truthfully say so, and not hold out false hopes to the producer and the Congress.

that some change can be made in the ceiling rates through special relief proceedings. The reason for cost imprecision and costing methods were clearly explained by the Commission in its *Texas Gulf Coast Area Rate Case*, 45 F.P.C. 674, where the Commission discussed for some eleven pages (45 F.P.C. 691-702) the various elements of imprecision in only one of the three costing methods which it has utilized. We urge the Commission to reread again this discussion, and conclude, as the Commission did at 45 F.P.C. at 702-03, that "cost calculations are not 'costs' in the direct sense, but rather judgmental choices of data, and judgmental choices of allocation of joint costs."

C. **The End Result Test — What Is In The Best Interest Of The Consumer?**

All of the major rate cases, beginning with the *Hope* case[4] through *Permian* and *Mobil*, and all of the area rate decisions in the Circuit Courts, emphasize that the

[420]

Commission should consider the end result of its actions, and that its efforts should be to obtain an adequate supply of gas at a reasonable cost. We submit that the Initial Decision here completely loses sight of that objective, and instead adopts a course of action which inevitably must restrict supply and increase consumer costs.

1. **The Question Of Gas Supply.**

The evidence in this proceeding shows that not only Shell but also Pennzoil Producing Comapny ("Pennzoil") and United Gas Pipe Line Company ("United"), the pipeline purchaser, view with extreme seriousness the action by the

[4] *F.P.C.* v. *Hope Natural Gas Co.*, 320 U.S. 591 (1944).

Williams to cancel the lease or to base their royalty payments on the current market of gas, which they have contended to be $1.40 per Mcf. If the Louisiana State Court should deny the lessors' claim for cancellation but grant it claim for royalty based on market value, the 1952 Lease would have to be released, as there is a net revenue deficit on this Lease of 3.15 cents per Mcf for each cubic foot of gas sold after such a judgment. Judge Gordon dismisses the concern expressed by all of the parties except the Commission Staff for the possible loss of the entire gas stream to the interstate market by the following reasoning:

(a) Shell may prevail in its lawsuit against the lessors;

(b) Shell can still accept the settlement rate of 78 cents per Mcf without its royalty and operating costs exceeding its net revenues; and

(c) Even if the lessors get the title to all of the gas, the gas must stay in interstate commerce under the Commission's decision in *El Paso Natural Gas Company*, Opinion Nos. 737 and 737-A, issued July 11, 1975 and September 3, 1975, respectively.

It is noteworthy with United, faced with severe curtailment problems, does not share the analysis of the

[421]

public interest adopted by Commission Staff and Judge Gordon. On the contrary, United views with extreme seriousness the possibility of losing a substantial portion of its gas supply, see Tr. 65-67. It is also noteworthy that no consumer has intervened in opposition to Shell's Petition. On the first point made by the Presiding Judge, the probability of prevailing in State Court in the lawsuit against the Wil-

liams, Shell will not, for obvious reasons, attempt to brief this issue to the Commission from the viewpoint of its opponent in the State Court, the lessor-royalty owner.

The Presiding Judge is also in error in his interpretation of the settlement and his conclusion that if Shell and Pennzoil are willing to pay royalty based on a 78-cent price that the Williams will have to accept it and settle the litigation. On the contrary, the settlement agreement provides that the Williams are entitled to the *higher* of the base royalty rate of 78 cents or the "base alternative rate", which is defined as 150 percent of the highest area of national rate permitted. Under the current National Rate For New Gas, this rate level is approximately 90 cents per Mcf. Should the Commission in Docket No. RM75-14, the Biennial Review Proceeding, increase the national rate, this alternative rate will go up to 150 percent of whatever the new national ceiling rate may be. Therefore, the Williams also would have the right to reject the settlement even if Shell and Pennzoil were willing to pay royalty on the basis of 78 cents per Mcf.

On the third question, whether the gas must continue to be sold to United in interstate commerce if the Williams are successful in obtaining title to the leases, the outcome is also far from certain. The *El Paso* case is currently pending on appeal in the Fifth Circuit, see *Southland Royalty Company* v. *F.P.C.*, Case No. 75-2851. Moreover, under *Mobil Oil Corporation* v. *F.P.C.*, 463 F.2d 256 (D.C. Cir. 1971), cert. denied, 92 S.Ct. 2409, the reversion of the lease to the lessor, so that under the "merger" doctrine the lessor owns the full title to the property, may remove the entire gas stream from FPC jurisdiction.

[422]

In all of the uncertainty as to the ultimate question of how much gas will remain in interstate commerce, one thing

is certain — the outcome of the various lawsuits required to resolve the above question will remain in doubt for several years in the future. The testimony in this case shows clearly that one well has been deferred for some three years because of this litigation, and that Pennzoil is also contemplating some development wells which cannot be drilled until the cloud of the lawsuit has been removed. As long as the litigation continues, additional capital investments cannot be made on the leases in question. Thus, the production from the reservoirs must be allowed to decline and with the resulting deterioration of United's supply. All of this effect is discounted by Judge Gordon by the statement that Shell refused to "promise" that it would engage in additional development should the special relief be granted. What Shell did say was that it had planned and budgeted a well on the Williams' Leases at the time the litigation was commenced. After a lapse of some three years, in today's inflationary economy, it is necessary to re-evaluate the costs involved against the revenues hopefully to be received before an affirmative commitment can be made. Such an evaluation cannot be made until the Commission's decision is issued and the circumstances are known.

2. The Question Of Cost To The Consumer.

If the Commission were to grant the special relief requested, to flow through the higher royalty cost, in the case of Shell there would be an increase in the ceiling of 3.6 cents per Mcf under the 1934 Lease and 9 cents under the 1952 Lease (Initial Decision, p. 9). Should the Williams succeed, either in canceling Shell's lease or in obtaining a royalty payment based on the price which is so high that Shell could not continue to operate the lease, the Williams would then succeed to eight-eighths (8/8ths) of the production attributable to these leases. If the Commission

were to prevail and subsequent litigation with Williams under the theory set out in the *El Paso* decision, *supra*, so that the gas must continue to be sold in interstate commerce, there still remains a question of the price at which such gas

[423]

would be sold. Under existing Commission decisions, Williams would have no contract to sell gas to United, as the contract would terminate at the same time Shell's lease terminates. Should the Williams thereafter enter into a new contract with United, under the Commission's Opinion Nos. 699 and 699-H, all of this gas would be entitled to the National Rate For New Gas, currently at 58-59 cents (including Btu adjustment). As this price would be received for the full eight-eighths (8/8ths) of the production, not one-eighth (1/8th) or one-fourth (1/4th) of such production, the overall price to the consumer would be 16.4 cents per Mcf *higher* under this result than under Shell's proposal for the 1934 Lease and 8.4 cents per Mcf *higher* for each Mcf sold under the 1952 Lease, compared to Shell's proposal. If the Williams were successful in obtaining a small producer certificate, the differential would be even greater.[5]

Judge Gordon's conclusion is to require Shell to continue to operate the leases, even though its gas revenues are at a loss, and subsidize its gas operation by sale of the liquid products. Depending on the price ultimately determined as the basis for the calculation of royalty, this course represents a marginal operation at best and at worst, illegal confiscation.

[5] Judge Gordon concludes that the Williams would not be entitled to a small producer certificate because current gas sales attributable to the leases in question exceed 10 million Mcf per year (p. 22). He does not address the question of how long the current production rate will continue in the absence of further capital investment on these leases. There is certainly no reason to expect that the current rate of production will continue for some indefinite period in the future.

IV.
CONCLUSION

This case will be one of the first considered by the new Dunham Commission. Writing on virtually a

[424]

clean slate, this Commission must decide whether it will follow the policies of the Nassikas Commission and attempt to weigh the effects of its decisions on the gas supply, viewing the consumer interests in its broader aspect, or whether it will revert to the theory practiced by the Swidler and White Commissions of holding producer prices strictly to cost determinations, which are admittedly imprecise, and rest on judgmental selections of methods designed to obtain the lowest possible result. It requires but a brief look at history to see the result of these two alternative policy positions by the Commission. The policy of the Swidler-White Commission led to reduced prices, reduced supply, increased demand, and the gas crisis of mounting proportions. The policy of the Nassikas Commission attempted to reverse that trend, and has been successful in increasing the exploration and production effort by the industry, although this increased effort is not still enough to keep up with increased demand. As charged by the Court decisions, we urge the Commission to carefully consider the "end result" of its decision in this proceeding.

Respectfully submitted,

Thomas G. Johnson
William G. Riddoch
Attorneys for
SHELL OIL COMPANY
By /s/ THOMAS G. JOHNSON
Thomas G. Johnson

December 19, 1975

[448]

UNITED STATES OF AMERICA
FEDERAL POWER COMMISSION

Before Commissioners:
Richard L. Dunham, Chairman;
Don S. Smith, John H. Holloman III,
and James G. Watt.

Pennzoil Producing Company
Docket No. RI76-8
Shell Oil Company
Docket No. RI76-10

OPINION NO. 753
OPINION AND ORDER
DENYING SPECIAL RELIEF AND ABANDONMENT

(Issued January 30, 1976)

Pennzoil Producing Company (Pennzoil) on July 1, 1975, and Shell Oil Company (Shell) on July 18, 1975, filed applications seeking special relief from the just and reasonable rates[1] established under Opinion Nos. 598[2] and 699[3] in order to flow through to their customer, United Gas Pipe Line

[1] Sections 4(a) and 5(a) of the Natural Gas Act, require that all rates received by a "natural gas company" be "just and reasonable". 52 Stat. 822, 823 (1938); 15 U.S.C. §§ 717c(a), 717d(a) (1970).
See, e.g., FPC v. *Texaco Inc.*, 417 U.S. 380 (1974).

[2] *Area Rate Proceeding et al. (Southern Louisiana Area)*, 46 FPC 86 (1971), *aff'd sub nom. Placid Oil Co.* v. *FPC*, 483 F.2d 880 (5th Cir. 1973); *aff'd sub nom. Mobil Oil Corp.* v. *FPC* 417 U.S. 283 (1974).

[3] *Just And Reasonable National Rates For Sales Of Natural Gas From Wells Commenced On Or After January 1, 1973, And New Dedications To Interstate Commerce On Or After January 1, 1973*, Docket No. R-389-B, Opinion No. 699, 51 F.P.C. 2212 (June 21, 1974), *reh. denied*, Opinion No. 699-H, 52 F.P.C. (December 4, 1974, *aff'd sub nom. Shell Oil Co.* v. *FPC*, 520 F.2d 1061 (5th Cir. 1975).

Company (United), higher royalty rates called for in a settlement agreement dated June 18, 1975, with their lessors, Williams, Inc. and others (Williams).

[449]

The gas involved is produced in the Gibson Field, Terrebonne Parish, Louisiana, from leases with Williams dated August 29, 1934, and July 24, 1952. The 1934 lease provides for payment of a royalty equal to one eighth (1/8) of the value of the gas produced calculated at the "market rate" prevailing at the well. The 1952 lease provided for a royalty of one-fourth of the value of the gas calculated at the "market price" prevailing at the well. By letters dated June 7, 1973, and March 27, 1974, Williams demanded payment by Shell and Pennzoil of royalties based on market values ranging from 35 cents to 70 cents per Mcf for the period October 1, 1971, through December 31, 1973, and 70 cents per Mcf thereafter. By letter of June 5, 1974, Williams purported to terminate the leases (Exhibit No. 3).

On May 24, 1974, Shell and Pennzoil filed a petition in the Civil District Court in the Parish of Orleans, Louisiana[4] praying for a Judgment declaring that the petitioner's interpretation of "market rate" and "market price" was correct, that they have properly discharged their royalty obligations on the basis of Commission established rates and that the leases are still in effect (Exhibit No. 4). They also asked for a temporary restraining order which was granted. Williams filed an answer and reconventional demand (counterclaim), with an amendment alleging market prices for the gas for the period October 1, 1971, to April 30, 1975, ranging from $.35 to $1.40 per Mcf and underpayments of $3,731,683.79 (Exhibit Nos. 5, 6).

[4] *Shell Oil Company and Pennzoil Producing Company* v. *Williams Inc., et al*, Civ. D.Ct. Orleans Parish, La., Docket No. 573-581.

In the settlement of June 18, 1975, Pennzoil and Shell would apply to the Commission for authority to pay a royalty based on a price of 78 cents per Mcf for 1975 and 1.5 cents per Mcf more each year or 150 percent of the highest area or national rate permitted, plus Louisiana severance tax, Federal taxes and Btu adjustment. Alternatively, Pennzoil and Shell would ask for authority to deliver to Williams one-eighth or one-fourth, as the case may be, of the gas attributable to their respective interests, and to abandon their sales of this gas to United.

[450]

If the Commission approves the price alternative, Pennzoil and Shell would pay a royalty for 1974 equal to what would have been paid based on a price of 45 cents per Mcf, but only to the extent the Commission permits them to recover such amounts from United. If the Commission approves the alternative delivery of the gas to Williams, Pennzoil and Shell would pay an additional royalty until the date of a final order.

After the Commission's order becomes final and non-appealable the parties would dismiss their Louisiana civil suit. Pennzoil and Shell are to use their best efforts to obtain the approval of the Commission. If the Commission refuses to do so on or before February 1, 1976, either Williams or Shell and Pennzoil, acting together, may terminate the agreement. In separate agreements United agreed to make the additional payments or to release the royalty gas (Exhibit Nos. 7, 8).

In its order of August 29, 1975, the Commission denied the petitions of Pennzoil and Shell for special relief and prescribed a hearing on the issue relating to the abandonment of the royalty gas. On September 22, 1975, the Commission granted rehearing and provided that the hearing cover the issue of special relief. The hearing was held

before Presiding Administrative Law Judge Samuel Z. Gordon on September 23, 1975, at which Shell, Pennzoil and United presented evidence. Shell was afforded additional time to present certain factual data as to prices, volumes and cost and did so on September 29, 1975. The costs it presented were derived from national costs with a figure for operating expenses from the 1934 and 1952 leases substituted for the national figure. Shell was given opportunity to file additional cost data but advised that it did not intend to do so (Exhibit No. 10), although it filed answers to written interrogatories submitted by the Commission staff.

In his initial decision issued November 24, 1975, the Judge denied special relief on the ground that the producer must establish that his overall costs incurred in the operation of the particular well or group of wells are higher than area or nationwide rates, or that his out-of-pocket expenses will exceed revenues. Pennzoil, he said, had made no such showing and Shell had attempted to use the nationwide costs with a 4.5 cents figure for operating costs and a royalty figure based on $1.40 per Mcf market value.

[451]

The Judge also determined that Pennzoil and Shell have not established that abandonment of the royalty interest is permitted by the public convenience and necessity. Williams has agreed to accept higher royalty payments computed on the basis of 78 cents per Mcf, he pointed out, and Shell has shown that it could absorb higher royalty costs while Pennzoil has not made a showing that it could not. Furthermore, the abandonment should be denied because William's claim is unadjudicated. He would also deny the requested surcharge for past royalties.

Exceptions were filed by Pennzoil, Shell, United, Mobil Oil Corporation (adopting those of Pennzoil and Shell) and

the State of Louisiana, and a brief opposing exceptions was filed by Staff.

Since the filing of the exceptions Pennzoil on January 20, 1976, filed a motion for leave to lodge a document with the Commission and to comment on the Commission's Opinion No. 749[5] prescribing rates for flowing gas. The document is a letter dated January 5, 1976, from counsel for Williams requesting answers to interrogatories in the Louisiana litigation and stating that Williams intended to reactivate the state proceedings as soon as possible under the settlement agreement. In its comments on Opinion No. 749 Pennzoil says that, as to the old gas, the royalty increment under the settlement would be added to the Opinion No. 749 rate,[6] rather than to the Southern Louisiana Area rate. Pennzoil argues that the Opinion No. 749 rate[6] should apply even though it is granted special relief here[7] because this is not a typical relief case since all increased sums will be passed directly to the lessors. Since we are denying the requested relief as discussed below, it is not necessary to determine this issue.

[452]

Pennzoil objects to the Judge requiring project cost evidence, saying that the cost inquiry should be limited to the costs and revenues associated with the price increase. It argues that the risks of the Williams litigation render the current price inappropriate and lease termination is a serious possibility. If Williams wins in the litigation,

[5] *Just And Reasonable National Rates For Sales Of Natural Gas From Wells Commenced Prior To January 1, 1973,* FPC Opinion No. 749, Docket No. R-478, F.P.C. (December 31, 1975).

[6] The Opinion No. 749 rate is 23.5 cents per Mcf 23.5 cents per Mcf prior to July 1, 1976, and 29.5 cents per Mcf thereafter, subject to adjustments.

[7] See Opinion No. 749, at 48-49.

Pennzoil says, it might be able to sell the gas in intrastate commerce, or it might sell all of the gas under a new contract at 130 percent of the national rate under Section 2.56a(a)(2)(iii) of the Regulations[8] and Opinion No. 742[9], and for all of the gas this would be 27 cents per Mcf more than Pennzoil is currently collecting. It further contends that market value royalties involve considerations different from those involved in the determination of other items of cost since royalties are flowed-through to the lessor. Finally, its notes that substantial risks are avoided by an increase in average price from 40.91 cents per Mcf to 44.55 cents per Mcf or 3.64 cents, none of which inures to Pennzoil's benefit.

Shell makes similar arguments about the lack of necessity for showing overall costs, saying that proof of overall costs is not required in a special relief case. Likewise Shell argues that failure to approve the settlement risks interstate gas supply and threatens higher prices, and asks the Commission to consider the end result. United urges that the settlement be approved in the public interest as concerned with the certainty of gas supply and reasonable prices. Louisiana argues that the Judge failed to apply proper standards in denying rate relief contending that changed circumstances have made no longer appropriate the royalty cost assumptions that went into the applicable rate structures, and Louisiana supports the settlement as a reasonable and appropriate resolution of the issues. On the other hand the staff argues against reliance on non-cost

[453]

factors and Shell's use of national cost figures, which it points out are only averages.

[8] 18 C.F.R. § 2.56a(a)(2)(iii).

[9] *Small Producer Regulation*, Docket No. R-393, Opinion No. 742, FPC

PRICE RELIEF

The real issue in this proceeding is whether the Federal Power Commission can legally grant any form of rate relief above either an area or nationwide just and reasonable rate solely because the producer selling the gas in interstate commerce *may* be obligated to make a royalty payment based not upon the regulated price the producer receives for the gas, but rather on the "market value" of the gas. Moreover, as in this proceeding, the question becomes somewhat speculative because of litigation between producer lessees and lessors over the extent of such royalty obligations.

While sympathetic to the plight of the producers who face or may face litigation on the value of royalties, we today must find that such producers are not entitled to rate relief. While we admittedly do not have jurisdiction over royalty owners as such[10] and, therefore, over royalty payments by producers to lease owners, we do have jurisdiction over the rates charged by producers to the pipelines for sales of gas for resale in interstate commerce and those rates must be "just and reasonable".[11] Hence, if a producer desires to compute royalty payments based on a rate in excess of our applicable just and reasonable rate, he may unilaterally do so. However, if a producer attempts to flow this cost through to the pipeline and ultimately to the consumer, we must determine if this *incremental royalty cost* is just and reasonable. Yet, in making this finding, it would be inconsistent and contrary to the Commission's mandate to establish a just and reasonable rate and at the same time allow a producer selling at that just and reasonable rate to increase this rate for additional royalty payments which are based on other factors than the regulated rate.

[10] See *Mobil Oil Corporation* v. *FPC*, 4[illegible] F.2d 256 (D.C. Cir. 1972).

[11] See *Mobil Oil Corporation* v. *FPC*, *et al.*, 417 U.S. 283 (1974); *FPC* v. *Texaco, Inc.*, 417 U.S. 380 (1974).

[454]

In the instant proceeding, the impetus of the settlement is the market value of the royalties and no consideration has been given to regulated rates. As such, we cannot permit any incremental royalty costs resulting from this settlement, or resulting from any judgment by a state court regarding royalty payments, to be passed on to the pipeline if these incremental royalty costs are based on any other factors than the regulated just and reasonable rate. On this point, we note the Supreme Court's warning in *FPC* v. *Texaco, supra*, that the Commission is not free to equate just and reasonable rates with the prices for gas in the marketplace. Accordingly, we believe that we are not free to allow royalty costs, which are based on market values, to be passed on to the pipelines as just and reasonable rates. A contrary result would not "... afford customers a complete, permanent, and effective bond of protection from excessive rates and charges".[12]

[455]

ABANDONMENT

Pennzoil argues that abandonment of the royalty portion of the gas should be allowed under Section 7(b) of the Natural Gas Act[13] as in the public convenience and necessity if price relief is not granted. Pennzoil says the choice here is

[12] See *Atlantic Refining Company* v. *Public Service Commission of the State of New York*, 360 U.S. 378, 388 (1959).

[13] Section 7(b) provides:

> No natural-gas company shall abandon all or any portion of its facilities subject to the jurisdiction of the Commission, or any service rendered by means of such facilities, without the permission and approval of the Commission first had and obtained, after due hearing, and a finding by the Commission that the available supply of natural gas is depleted to the extent that the continuance of service is unwarranted, or that the present or future public convenience or necessity permit such abandonment.

52 Stat. 824 (1938); 15 U.S.C. § 717f(b) (1970).

between losing one-eighth of the gas and risking the loss of all of the gas. While United prefers the requests for increased rates, it says the Commission should approve the requests to abandon the royalty portion of the gas if price relief is denied.

We find no reason to grant abandonment on the basis of this record. There is no showing "that the available supply of natural gas is depleted to the extent that the continuation of service is unwarranted, or that the present or future public convenience or necessity" requires that abandonment be authorized.

The supply of natural gas involved in this case is not depleted so abandonment may not be approved for that reason. Moreover, the public convenience and necessity, present or future, is not served by granting an abandonment authorization that would likely result in the subject gas being diverted from the interstate market to the intrastate market.

[456]

Since "there can be no withdrawal of that supply [of natural gas] from continued interstate movement without Commission approval"[14] once the gas is dedicated, we do not share the concern of Pennzoil and United that Williams could terminate deliveries to United even if the leases were cancelled as a result of state court litigation. If the lease were cancelled and Williams were to undertake to sell the subject gas, Williams would simply assume the obligations of Pennzoil and Shell to continue service to United. *El Paso Natural Gas Company, Texaco Inc.*, Docket Nos. CP75-209, CI75-594, Opinion No. 737, ___ F.P.C. ___ (July 11, 1975), *rehearing denied,* Opinion No. 737-A, ___ F.P.C. ___ (September 3, 1975), *rehearing granted* on limited issue, Opinion No. 737-B, ___ F.P.C. ___ (December 18, 1975), *appeal*

[14] *Atlantic Refining Co.* v. *Public Service Commission of New York*, 360 U.S. 378, 389 (1959).

pending sub nom. Southland Royalty Co. v. *F.P.C.*, No. 75-2851 (5th Cir.). In such a case, Williams would not be entitled to the status afforded a royalty owner by *Mobil Oil Corp.* v. *F.P.C.*, 463 F.2d 256 (D.C. Cir. 1971), but would be a natural gas company making sales for resale of natural gas in interstate commerce subject to the Commission's jurisdiction. *Phillips Petroleum Company* v. *Wisconsin*, 347 U.S. 672 (1954). We, therefore, deny the alternative requests for abandonment.

SURCHARGE

Pennzoil argues that the surcharge contained in the settlement to pay Williams for alleged past underpayment of royalties was not settled in the Commission's orders, is not a retroactive rate increase, represents less than the full

[457]

claim and should be allowed. For the reasons set forth above in denying the requested price relief, we also deny the requested surcharge.

The Commission further finds:

The initial decision issued November 24, 1975, in these proceedings denying the applications of Pennzoil and Shell for special relief or abandonment, and a surcharge should be affirmed for the reasons set forth above.

The Commission orders:

(A) The initial decision issued November 24, 1975, in these proceedings is affirmed for the reasons set forth above.

(B) The petitions of Pennzoil and Shell requesting special relief or abandonment and a surcharge are denied.

(C) The motion to lodge a document and comment filed on January 20, 1976, is granted.

(D) Exceptions not granted are denied.

By the Commission.

(SEAL)

Kenneth F. Plumb,
Secretary.

[458]

UNITED STATES OF AMERICA
FEDERAL POWER COMMISSION

PENNZOIL PRODUCING COMPANY
Docket No. RI76-8

SHELL OIL COMPANY
Docket No. RI76-10

PENNZOIL PRODUCING COMPANY'S
PETITION FOR REHEARING

Pursuant to Section 19(a) of the Natural Gas Act and Section 1.34 of the Commission's Rules of Practice and Procedure, Pennzoil Producing Company (Producing) hereby petitions the Commission for rehearing of its Opinion No. 753 issued in this proceeding on January 30, 1975, and respectfully requests expedited treatment of this petition in order that a decision on rehearing may be issued no later than March 1, 1976.

In support hereof, Producing respectfully states:

I.

INTRODUCTION

Producing is selling at applicable Commission ceiling prices gas produced from acreage leased from Williams, Inc. (Williams). Producing is paying royalty to Williams based on the ceiling rates Producing is collecting for the sale of the Williams acreage gas, but Williams has demanded royalty payments based on prices in excess of such rates. Litigation has resulted in which Williams seeks to have a Louisiana state court (1) declare the lease terminated and (2) assess damages for alleged underpayment of royalties. Producing has asked the court to enjoin Williams from terminating the lease and to declare that Producing has been and is paying the correct royalty.

By its application in this proceeding, Producing seeks Commission action which will allow implementation of an agreement in settlement of the Williams litigation. The settlement can be implemented if the Commission authorizes Producing to increase the price charged for gas sold from the Williams acreage in an amount exactly equal to the increased royalty payments that Producing would make to

[459]

Williams under the settlement. Royalties under the settlement would be based on the higher of 78¢ per Mcf[1] or 150% of the highest national or area rate permitted. In the alternative, the settlement can be implemented if the Commission authorizes abandonment of the sale of the royalty share of the gas so that Williams may take that royalty share in kind. In Opinion No. 753, the Commission rejected both alternative requests. In addition, although the issue was not presented in this case, the Commission stated that it had no authority to allow a producer to reflect in its rates excess royalty costs even when such costs are incurred as a result of a court judgment.

The settlement which forms the basis for Producing's application provides that either party may cancel the agreement if the requisite Commission authorization is not obtained by February 1, 1976. While that date is now past, Producing firmly believes that the Commission erred in rejecting the application. Therefore, Producing has sought and received Williams' assurance that although the Wil-

---

[1] Plus 1.5¢ annual escalations beginning January 1, 1976. In addition, Producing seeks approval to collect a surcharge that would also be passed through to Williams under the settlement. The surcharge is in settlement of Williams' claims as to alleged past underpayment of royalties and represents an amount far less than Williams claims. Implementation of the settlement is not dependent upon approval of the surcharge.

liams litigation will now proceed, the settlement will not be cancelled before March 1, 1976. Consequently, should the Commission on rehearing, on or before March 1, 1976, authorize the royalty flow through or the abandonment request, the settlement may still be implemented.

II.

SPECIFICATION OF ERRORS

A. **The Commission Erred In Denying Producing's Excess Royalty Flow Through Request.**

B. **The Commission Erred In Stating In Dicta That Excess Royalty Costs Incurred As A Result Of A Court Judgment May Not Be Recovered In Producer Rates.**

C. **The Commission Erred In Denying The Alternative Abandonment Request.**

[460]

D. **The Commission Erred In Denying The Surcharge Request.**

III.

ARGUMENT

A. The Commission Erred In Denying Producing's Excess Royalty Flow Through Request.

1. The Commission Has Authority to Allow Increased Rates to Reflect Royalty Payments Based on Prices in Excess of Ceiling Rates.

In rejecting the excess royalty flow through, the Commission expressed concern for the problems created by excess market value royalty litigation. In addition, the Commission held that in passing upon rate increase requests based solely upon such costs "... we must determine if this *incremental royalty cost* is just and reasonable." Opinion No. 753 at 6 (emphasis in original). Producing has no quarrel with these two findings. Yet despite establishing this stand-

ard, which of necessity requires a determination of whether the incremental excess royalty costs were prudently incurred, the Commission concluded that the Natural Gas Act precludes recovery of such costs regardless of the circumstances under which they were incurred. On this point the Commission erred.

Both the United States Supreme Court and the Fifth Circuit have already held that the Commission does have authority to allow rate adjustments to reflect royalty costs based on prices in excess of Commission ceiling prices. *Placid Oil Co.* v. *FPC,* 383 F.2d 880 (5th Cir. 1973), aff'd. *sub nom. Mobil Oil Corp.* v. *FPC,* 417 U.S. 283 (1974). That determination was made in the context of the review of the Commission's Opinion No. 598 which established an area rate for Southern Louisiana. Mobil Oil Corporation contended that the royalty component of the rate there established was inadequate because it failed to take account of the possibility of the precise type of royalty costs involved in this proceeding, *i.e.,* royalties based on prices in excess of the ceiling rate. The Fifth Circuit responded to this contention by holding that the royalty component was adequate since not all producers faced excess royalty costs and those who did had the opportunity to obtain relief through individualized proceedings:

[461]

> If, as subsequent events develop, the producers are put in a bind by their royalty obligations, they may *certainly* petition FPC for individualized relief.
>
> * * * *
>
> If the royalty obligations are such as to make the rates established by Op: 598, and approved by us here, confiscatory or otherwise inappropriate, those producers who are materially affected will *certainly* have recourse to the administrative process. 483 F.2d at 911 (emphasis added).

The Supreme Court spoke to this precise point, and affirmed the Fifth Circuit's determination that individualized relief is an available remedy for royalty costs based on prices in excess of ceiling rates, holding that "... an affected producer is entitled to seek individualized relief." 417 U.S. at 328.

Producing does not contend that *Placid Oil* and *Mobil Oil* establish the prudence of the excess royalty costs in this case. The evidence establishes that fact. But without question *Placid Oil* and *Mobil Oil* do establish that the Commission has the authority to allow price relief for royalty costs based on prices in excess of ceiling rates. The Commission's determination to the contrary, which was the sole basis for rejecting the royalty flow through, is therefore erroneous.

The Commission's determination that it has no authority to allow flow through of excess royalty costs was based on the view that "the Commission is not free to equate just and reasonable rates with the prices for gas in the marketplace", citing *FPC* v. *Texaco,* 417 U.S. 380 (1974). The Supreme Court, however, certainly saw nothing in this general principle that would preclude flow through of excess market value royalty costs since the Court's determination in *Mobil Oil* that a producer can seek rate relief on the basis of such costs was made the same day *Texaco* was decided.

In fact, the *Texaco* decision fully supports Producing's position in this case. To be sure, the Court did state the general rule that an entire rate cannot be based *solely* on market prices. But the Court was careful to discuss the reason for this rule and the resulting limitations on the rule. The Court pointed out that the reason for the rule is that the basic premise of the Natural Gas Act is that market prices will generally be too high, *i.e.,* generate "excess profits." Thus the basic purpose of the Act was to

protect consumers from rates which allowed "excess profits." Yet if an entire rate is based solely on market prices, no basis for determining the level of profits will generally exist. By the same token, if the reason for the rule, *i.e.,* no evidence as to profits, is not present in an individual case the rule has no application:

> "This does not mean that the market price of gas would never, in an individual case, coincide with just and reasonable rates or not be a relevant consideration in the setting of area rates ...; it may certainly be taken into account along with other factors, ..." 417 U.S. at 380.

The price increase request in this case is not based solely on market prices. To the contrary, it is based on a number of factors, including the risks of the Williams litigation, the propriety of the settlement, and the absence of any excess profit to Producing as a result of the price increase. Producing would continue to receive for itself only the revenue found by the Commission in the various area and national rate cases to be just and reasonable. Moreover, the amount of the price increase is not based on market prices. It is based on prices far below intrastate prices. Thus market price considerations are involved only to the extent that they gave rise to the litigation. Under *Texaco,* far from precluding the relief Producing seeks, that fact is simply "a relevant consideration" that must be weighed in Producing's favor.

Furthermore, as recognized in *Texaco* there may be individual cases in which a price increase based solely on market prices will be just and reasonable. Of course, one such case would be when the evidence establishes that the price does not allow "excess profits". The incremental price increase in this case is based on exact incremental costs, and

none of the revenue generated by that price increase inures to Producing's benefit. Thus, even if the incremental price increase in this case were viewed as based solely on market prices, under *Texaco* it would still be just and reasonable because the uncontroverted evidence establishes that Producing's profit will not increase one cent.

The Courts of Appeals have reached the same result as *Texaco* and for the same reason. For example, in *Consumers Federation of America* v. FPC, 515 F.2d 347 (D.C. Cir. 1975), the Court held that a rate collected under Order No. 491 cannot be deemed just and reasonable *solely* by reference to market prices. Similarly, in *MacDonald* v. *FPC*, 505 F.2d 355 (D.C Cir. 1974), the Court stated that the entire special

[463]

relief rate there involved could not be justified *solely* by reference to market prices. Again, the Court noted that if the rate were established solely on the basis of market prices, the level of the producer's profits could not be ascertained, thereby permitting a result possibly inconsistent with the basic purpose of the Gas Act, which was said to be the "protection of the consumer from profiteering in the gas industry." 505 F.2d 363.

Thus the Courts have held only that an entire rate may not be deemed to be just and reasonable based *solely* on market prices when there is no evidence as to the producer's profits under that rate. The justness and reasonableness of an incremental price increase reflecting exactly corresponding incremental costs based in part on market price considerations is an entirely different question. When an entire rate is under consideration as it was in *Texaco, MacDonald,* and *Consumers Federation,* then the level of profits is also involved. But when only an incremental cost is involved, no

question of "excessive profits" exists. By its very nature, a price increased based on incremental costs cannot possibly generate "excess profits" because the increased revenue will be sufficient only to cover the exact amount of the increased costs. Therefore, when the question is simply whether an incremental cost is just and reasonable, as the Commission has stated the issue to be here, the general rule proscribing a rate based solely on market prices is inapplicable. The Supreme Court's holding in *Mobil Oil* that individualized price relief is available for royalty costs based on prices in excess of ceiling rates is therefore not inconsistent with the Court's simultaneous holding in Texaco that an entire rate cannot be based solely on market prices. The Commission's reliance on *Texaco* is therefore misplaced. This case is governed by *Mobil Oil.* The Commission's determination that it has no authority to grant individualized relief on the basis of royalty costs based on prices in excess of ceiling rates is contrary to *Mobil Oil.*

In view of the *Mobil Oil* holding, the Commission's action in this case creates the precise result the Commission recently deemed to be ludicrous in *Gulf Oil Corp.* and *Texas Eastern Transmission Corp.,* Docket No. CI64-26 (Order issued Jan. 22, 1975). In that case, the Commission had allowed a party to intervene, but Texas Eastern asserted that the Judge nonetheless had power to restrict the intervenor's participation to the point where it would be meaningless. The Commission rejected this contention:

[464]

> "It would be small solace for a person to get the 'good news' from the Commission that it has been admitted as a party to a proceeding, only to be faced with the 'bad news' from the Judge that it cannot participate." Mimeo at 3.

Likewise, in this case it is small solace for Producing to get the "good news" from the Supreme Court in *Mobil Oil* that it can seek individualized relief, only to be faced with the "bad news" from the Commission that the Commission has no authority to grant such relief. The Commission's undue restriction of its authority is error.

In fact, the Commission has previously exercised the authority it denies itself in this case. In *American Petrofina Company of Texas (Operator), et al.*[2] the Commission granted a price increase above the ceiling rate to reflect the exact incremental costs of compression. In setting the area ceiling price involved in *American Petrofina,* the Commission had previously considered whether compression costs should be included, and, if so, the just and reasonable amount of such costs. The price increase authorized in *American Petrofina* therefore was based on an actual market cost in excess of that which the Commission had previously deemed to be just and reasonable.[3]

> "Because *American Petrofina* is currently charging the applicable area ceiling rate, its rate is just and reasonable without inquiry into its actual total costs of production. An increase in a just and reasonable rate to reflect the exact incremental costs per Mcf of compression expenses should not, of itself, deprive that rate of its just and reasonable character." *American Petrofina, supra* at 4.

American Petrofina therefore clearly establishes that the Commission has authority to permit flow through of an incremental cost which is based on the money required in

[2] Docket Nos. RI75-17 and RI75-19 (Order issued March 3, 1975).

[3] The Commission has reached an identical result in numerous compression cases: *See Pioneer Production Corp.*, Docket No. CI73-617 (Order issued November 21, 1975) and cases cited therein at footnote 2; *Sohio Petroleum Co.*, Docket No. RI76-47 (Order issued Feb. 9, 1976).

the market place for compression. And *American Petrofina* also establishes the standard to be used in determining

[465]

whether such flow through should be allowed.

This case is no different. Indeed the Commission has already determined that the standard set forth in *American Petrofina* is applicable here. And there is no basis for the Commission's conclusion that it has no authority to allow the flow through here even though it exercised such authority in *American Petrofina.* To the contrary, the Commission's authority is precisely the same in both cases. The Commission does not regulate the price upon which either compression expenses or royalty payments must be made, but in regulating the price of gas that is subject to its jurisdiction the Commission has determined what it deems to be a just and reasonable price, whether cost components for compression and royalty should be included in that price and, if so, the just and reasonable amount of those cost components. This previous determination was no barrier to allowing flow through of the actual market price of compression in *American Petrofina.* Likewise, the fact that the actual price that must be paid for royalties must be based on a price in excess of the just and reasonable price the Commission has set for sales subject to its jurisdiction does not preclude the price increase here. The Commission cannot legally, or equitably, treat some producers one way and Producing another.

In addition to the compression cases, the Commission's action in *El Paso Natural Gas Company*[4] is also inconsistent with its determination in this case that incremental market value royalty costs are necessarily unjust and reasonable. In the *El Paso* case, the Commission has author-

[4] Docket No. RP74-22, *et al.* (Order issued Nov. 29, 1974), reh'g denied (Jan. 29, 1975).

ized El Paso to increase its rates, subject to refund, to allow recovery of increased overriding royalties based on market value payments being made by El Paso pursuant to an agreement made in settlement of a controversy with the overriding royalty owners. These payments are being made, and the costs recovered by El Paso, despite the fact that the royalty is based on prices in excess of Commission ceiling prices.

Yet the Commission did not determine there, as it has here, that such costs are necessarily unjust and unreasonable. If such a determination had been made, the

[466]

increases based on the market value royalty costs would have been summarily rejected as being outside the Commission's authority.[5] Instead, the issue of the justness and reasonableness of such costs was set for hearing. The justness and reasonableness of the price increase based on incremental market value royalty costs must also be considered in this case.

In sum, the Courts have made clear that the Commission does have authority to allow a price increase to reflect increased royalty costs based on prices in excess of ceiling rates. In addition, the Commission has consistently allowed price increases to reflect exact incremental increased costs even though such costs are in excess of those previously deemed to be just and reasonable under the ceiling rate. And, in fact, the Commission has previously determined in *El Paso* that excess royalty costs based on prices above ceiling prices are not unjust and unreasonable as a matter of law.

[5] See *United Gas Pipe Line Company*, Docket No. RP75-109 (Order issued July 7, 1975), reh'g denied (Sept. 3, 1975); *United Gas Pipe Line Company*, Docket No. RP75-30 (Order issued September 4, 1975), reh'g denied (Oct. 22, 1975).

Indeed, any other result would be untenable. Under the Commission's holding in this case, costs would be unreasonable even though such costs (1) were prudently incurred (2) were absolutely essential in order to avoid lease termination or even higher costs which would reduce the funds available for exploration and development and (3) the price increase resulting from such costs would not generate a single penny of profit for the producer. There is nothing in either the Natural Gas Act or the courts' construction of that Act which requires a result so manifestly contrary to the public interest.

2. The Price Increase Is Just and Reasonable.

Since the Commission determined it was precluded as a matter of law from granting the royalty flow-through, the Commission did not address the factual question whether that price increase is just and reasonable. The Commission did set the standard by which the question must be judged, however. That standard is whether the "*incremental royalty cost* is just and reasonable."[6]

In *American Petrofina,* the Commission established the factors relevant to a determination of the justness and

[467]

reasonableness of an exact incremental cost. The costs in that case were for compression and in finding those costs to be just and reasonable, the Commission first determined that the price increase based on such costs would not increase the producer's profit. The Commission then concluded that the price increase based on those costs was justified because it was a reasonable price to pay for the benefits achieved.

In this case, there can be no dispute as to the profit question. Every penny of the price increase will flow directly

[6] Mimeo at 6 (emphasis in original).

through to Williams. The price increase cannot possibly generate any profit for Producing.

The record is equally clear that the price increase is a more than reasonable price to pay for the benefits achieved. This question was discussed at length in Producing's Brief on Exceptions. Basically, the price increase is justified because the Williams litigation involves substantial risks for gas consumers and those risks can be eliminated by settlement only if the price increase is approved. The Commission is certainly all too well aware that as a result of cases such as *J. M. Huber Corp.* v. *Denman*, 367 F.2d 105 (5th Cir. 1967) and *Mobil Oil Corp.* v. *FPC*, 463 F.2d 256 (D.C. Cir. 1971), *cert. denied* 406 U.S. 976 (1972), market value royalty litigation presents serious problems for both the producers this Commission regulates and the gas consumers whose interests the Commission is charged with protecting. Noone has denied that the outcome of the Williams litigation is unpredictable or that an adverse resolution of the litigation carries with it substantial risks to gas consumers. These risks are:

(1) In the event the lease were terminated, diversion of all of the gas from the interstate market so that the interstate consumer cannot obtain it at any price.[7]

(2) A price increase of at least 27¢ per Mcf if the lease were terminated and Williams sells the gas in interstate commerce at the small producer national rate.

[468]

(3) Either a price increase far in excess of that sought here if the lease is not terminated but royalty payments must be based on $1.40, or diversion to the lessor of substantial amounts of capital otherwise available for exploration and development.

[7] Whether the gas could be diverted from the interstate market if the lease were terminated is an open question which will be resolved in *Southland Royalty Co.* v. *FPC*, No. 75-2851, presently pending before the United States Court of Appeals for the Fifth Circuit.

The risks are therefore clear and the record is equally clear that the price increase which will avoid these risks will be about 3.64¢ per Mcf.[8] Whether 3.6¢ is a reasonable price to pay to avoid the adverse results otherwise possible is certainly a matter of judgment, but that judgment must be based on the record. Producing, Shell, and United all presented testimony that the price increase is reasonable and necessary to end the Williams litigation. At the same time, not a single one of United's customers, who will ultimately pay the price increase contemplated by Producing's application or bear the burden of an adverse resolution of the underlying legal issues, has expressed the slightest opposition to Producing's application. The amount of the increase is reasonable and the public interest demands that it be approved.

One final factor that may bear on the justness and reasonableness of the incremental royalty cost deserves comment in view of the Commission's statement that "if a producer desires to compute royalty payments based on a rate in excess of our applicable just and reasonable rate, he may unilaterally do so."[9] To the extent this implies that Producing was imprudent in entering into the market value lease in 1934 or intentionally and knowingly undertook to pay royalty based on prices in excess of ceiling rates, the implication is erroneous. No one has contended that the costs involved were imprudently incurred and indeed the facts show just the opposite. The lease was entered before the Natural Gas Act was even passed, twenty years before

[8] Exhibit 13.

[9] Mimeo at 6.

it was determined that the act covered producer sales,[10] and thirty-seven years before it was determined that the Act did not cover royalty owners.[11] At the risk of understatement, it would have been an unusually omniscient unregulated producer who would have foreseen that the law would develop in a manner that would require that producer to pay royalty on the basis of unregulated rates while at

[469]

the same time sell the same gas at one-third of those rates. The market value royalty costs in this case were prudently incurred and should be reflected in Producing's rates.

B. The Commission Erred In Stating In Dicta That Excess Royalty Costs Incurred As a Result of a Court Judgment May Not Be Recovered In Producer Rates.

This case involves increased costs based on a settlement of market value royalty litigation. It does not involve costs based on a court judgment. Nonetheless the Commission stated in its Opinion in this case that incremental market value royalty costs resulting from a court judgment cannot be reflected in a producer's rate.

The Commission does, of course, have authority to reflect in jurisdictional rates costs resulting from damages assessed by a court. *Cities Service Gas Co.*, Docket No. RP 71-106 (1973 Phase) (Order issued Sept. 5, 1974). Furthermore, as discussed above, the Commission also has authority to reflect in producers' rates costs resulting from the payment of royalties based on price in excess of ceiling rates. Therefore, the Commission's statement relating to court judgments, which is mere dicta, is erroneous for all

[10] *Phillips Petroleum Co.* v. *Wisconsin*, 347 U.S. 672 (1954).

[11] *Mobil Oil Corp.* v. *FPC*, 463 F.2d 256 (D.C. Cir. 1971), *cert. denied*, 405 U.S. 1074 (1972).

the reasons set forth above relating to the price increase based on the incremental royalty costs that are involved in this case. Indeed, the dicta exposes the flaw in the Commission's reasoning since under the dicta flowing from that reasoning the Commission has concluded that prudently incurred incremental royalty costs may not be reflected in producer rates even if such costs render those rates confiscatory.

But even if the Commission determines that it has no authority to allow the royalty flow through based on the settlement involved in this case, the dicta concerning royalties based on court judgments must be eliminated from the Commission's opinion. There may be any number of factors bearing on the propriety of price increases based on court judgments which are not pertinent to the issues in this case. Whether there are any such factors and, if so, what they may be cannot be determined on the basis of the record in this case, however, for the simple reason that the court judgment issue was not involved, was not briefed by the parties, and no evidence bearing on that extraneous issue is in the record. The statement is therefore unsubstantiated, unnecessary, and can only serve to prejudice the rights of parties who may appear before the Commission in the future. Accordingly, Producing respectfully requests that the statement be eliminated from the Opinion so that the issue may be decided in the proper context in the event it is ever presented.

[470]

C. The Commission Erred In Denying The Alternative Abandonment Request.

While Producing believes the royalty flow through is the preferable means for avoiding the risks to consumers presented by the Williams litigation, Producing also believes that the alternative abandonment proposal is far more con-

sistent with the public interest than encountering those risks. The Commission's sole reason for denying the abandonment request was that even if the litigation resulted in lease termination, the gas would still be sold in interstate commerce by Williams. If that did occur, the service which was voluntarily undertaken by Producing and Shell and is now being performed by experienced producers would be rendered on an involuntary basis by a royalty owner inexperienced in gas exploration, development, and production activities. As is expressly recognized in Section 7(e) of the Act, the public interest can be adequately served only by those "able and willing to do the acts and perform the service proposed." The public interest would therefore be disserved by the substitution of Williams for Producing and Shell.

Furthermore, as discussed above, whether dedication survives lease termination, while settled by the Commission,[12] is an open question on appeal. Undeniably, the Commission's tasks under the Natural Gas Act involve difficult questions. As a result, and also undeniably, the Commission is sometimes deemed to have decided those difficult questions incorrectly. In view of the fact that the Commission found it necessary to overrule its own prior precedent in determining that gas remains dedicated even after lease termination,[13] that question would seem to be a particularly close and difficult one. Producing submits that the public interest is better served by allowing abandonment of a fraction of the gas than by running the risk of losing it all.

D. The Commission Erred in Denying The Surcharge Request.

[12] *El Paso Natural Gas Co.*, Opinion No. 737, Docket No. CP75-209 (July 11, 1975), *reh'g denied*, Opinion No. 737-A (Sept. 3, 1975).

[13] *El Paso* v. *Bass*, Opinion No. 638, 48 FPC 1269 (1972) was overruled in Opinion No. 737-A at 3.

The surcharge request was denied for the same reasons the royalty flow through request was denied. For the reasons discussed above in connection with the royalty flow through request, the Commission erred in denying the surcharge.

[471]

IV.
CONCLUSION

The market value royalty problem has now been brought full circle. As a result of a combination of Court decisions, producers face the prospect of having to base royalty payments on unregulated intrastate prices while at the same time being required to charge a regulated rate less than one-third that amount for the sale of the same gas upon which such payments must be made. The possibility of this totally unreasonable and unconscionable result has been recognized for many years, and the courts have assured producers that individualized relief would be available in the event those fears were realized. The problem has now been realized, but the Commission has now said the courts' assurances cannot be fulfilled because the Commission has no authority to do so. The Commission's expression of sympathy for producers caught in this bind is understandable.

Fortunately, the Commission need not put itself in a position where it feels compelled to offer sympathy to those companies it regulates. For there is nothing in the Gas Act or the cases construing that Act which requires the result the Commission has reached. To the contrary, *Mobil Oil* precludes that result and the Commission's own previous action are inconsistent with it. The issue, therefore, is and must be whether, considering *all* the relevant factors, the price increase Producing seeks is just and reasonable.

On that issue the record is clear. Of primary importance, the record establishes that the price increase is consistent with the basic purpose of the Gas Act because it cannot possibly result in "excess profits." Furthermore, the increase is based on a cost that was prudently incurred and is an absolutely essential expense in order to avoid the substantial risks of the Williams litigation. Producing respectfully submits that the Commission erred in holding that a price increase that is so demonstrably just and reasonably must nonetheless be rejected as a matter of law.

[472]

Therefore, Producing requests that the Commission grant rehearing of its Opinion No. 753 issued in this case, and grant Producing's price increase and surcharge requests. In the alternative, Producing requests that the abandonment alternative be approved. In addition, in view of the time constraints involved, Producing respectfully requests the Commission to act expeditiously on this petition.

Respectfully submitted,

Stephen M. Hackerman

A. Duncan Gray, Jr.
Vice President and
General Attorney

Diane Barber
Pennzoil Producing
Company
900 Southwest Tower
Houston, Texas 77002

Jeron Stevens
Stephen M. Hackerman
3000 One Shell Plaza
Houston, Texas 77002

Bruce F. Kiely
Suite 300
1701 Pennsylvania
Ave., N.W.
Washington, D.C. 20006

Baker & Botts
3000 One Shell Plaza
Houston, Texas 77002
Attorneys for Pennzoil
Producing Company

[476]

UNITED STATES OF AMERICA
FEDERAL POWER COMMISSION

Pennzoil Producing Company
DOCKET NO. RI76-8

Shell Oil Company
DOCKET NO. RI76-10

APPLICATION FOR REHEARING

Comes now Shell Oil Company and applies for rehearing of the Commission's Opinion No. 753 in the captioned proceeding, pursuant to Section 1.34 of the Commission's Rules of Practice and Procedure (18 C.F.R. 1.34) and Section 19(a) of the Natural Gas Act (15 U.S.C. § 717r). In accordance with the aforesaid Section of the Commission's Rules, the following specifications of error are noted:

SPECIFICATIONS OF ERROR

1. The Commission has erred by failing to permit the implementation of a Settlement Agreement between Shell and Williams, Inc., which would resolve the pending litigation in the State Court of Orleans Parish, Louisiana. This Settlement could have been effectuated, either by the approval of an abandonment of the lessor's proportionate interest in the gas stream, or by permitting Shell to "flow through" the additional royalty payable to the lessor based on the royalty percentage being calculated on a price of 78 cents per Mcf. By refusing to grant either of these alternatives, neither of which would have resulted in any monetary advantage to Shell, the Commission has abused its discretion and committed a legal error.

2. In failing to consider the possibility that its adverse decision may result in a partial loss of the gas supply to United Gas Pipe Line Company, which is already

[477]

under severe curtailment, the Commission has failed to consider the "end result" of its decision and its impact of its decision on the consumer, and has therefore committed legal error.

3. In failing to consider the fact that, if Williams, Inc. prevails in the lawsuit in Orleans Parish, Louisiana with the result that Shell's leases are cancelled, or are made uneconomic to continue an operation because the royalty payments will exceed the total revenues to be received from the leases, in which event, cost to the consumer will increase more than the flow through of the rate requested here, the Commission has failed to consider the end result of its decision on the consumer, and has therefore committed legal error.

4. In establishing the area ceiling rate applicable to a portion of the gas being sold here, the Commission based its ceiling rates on a cost calculation utilizing a royalty cost of 15 percent of gross revenue received from the lease (*Southern Louisiana Area Rate Decision II,* 46 F.P.C. 86, at 132). In determining the national ceiling rate for new gas, which is applicable to the remainder of the gas involved in this proceeding, the Commission based its ceiling rate on a unit cost calculation which utilized a royalty percentage of 16 percent of gross revenue, see *National Rate Cases For New Gas,* Docket No. R-389-B, Opinion No. 699, 51 F.P.C. 2212, at 2272. The uncontested record in this proceeding shows that Shell may be required, if Williams, Inc. prevails in the State Court lawsuit to pay royalty rates which are greatly in excess of those utilized by the Commission in determining the area and national ceiling rates. The Commission has erred in refusing to permit the adjustment of Shell's rates to reflect these increased costs.

5. The Commission has erred in failing to allow special relief, which it had indicated to the United States Court of Appeals for the Fifth Circuit would be allowed, in situations where the royalty obligations under the lease placed the producers "in a bind" through no fault of their own, see *Placid Oil Co.* v. *F.P.C.,* 483 F.2d 880, at 911.

[478]

6. The Commission has erred in requiring project costs (referred to in the record as "overall costs") for the particular leases in question before considering whether to permit special relief to compensate producers for excess royalty costs which are over and above those costs contemplated in the area and national rate proceedings fixing the ceiling rate covering the area here in question. A requirement to utilize "project" costs is a basic change in producer regulation, and represents an abandonment of the theory of area ratemaking affirmed by the Supreme Court in the *Permian Basin Area Rate Cases,* 390 U.S. 747 (1968) and *Mobil Oil Corp.* v. *F.P.C.,* 417 U.S. 283 (1974), and thereby represents unlawful discrimination against Shell Oil Company in a manner prohibited by Section 4(b) and Section 5(b) of the Natural Gas Act (15 U.S.C.A. 717(c)(d).

7. In denying Shell's request for special relief unless Shell was able to submit project cost data which was physically impossible to compile within the time limit permitted by the Commission, the Commission has imposed rates upon Shell which may be confiscatory without granting Shell the opportunity to present evidence in support of those rates, and has therefore denied Shell due process of law as provided by the Administrative Procedure Act and the United States Constitution.

8. By providing in the area and national rate proceedings that producers were not entitled to any consideration in the area or national rate because of royalty clauses in oil

and gas leases which might permit the collection of royalty based on the market value of the gas, instead of the Commission's determined rate, and finding that those such problems should be dealt with in actions for special relief by the producer, and in turn by providing in actions for special relief from the same problem by producers the Commission was not authorized to grant such relief where the royalty was based on something more than the just and reasonable rate (Opinion, p. 6) the Commission has effectively foreclosed any consideration of the market value royalty problem in any forum, and has therefore deprived Shell of its property without due

[479]

process of law, by imposing a rate which may be confiscatory.

WHEREFORE, Shell Oil Company respectfully requests that the Commission grant rehearing of its Opinion No. 753, and that upon rehearing the Commission grant the special relief requested in Shell's Application.

Respectfully submitted,

Thomas G. Johnson
William G. Riddoch

Attorneys for
SHELL OIL COMPANY

By /s/ THOMAS G. JOHNSON
Thomas G. Johnson

February 12, 1976
Houston, Texas

[483]

UNITED STATES OF AMERICA
FEDERAL POWER COMMISSION

Pennzoil Producing Company
Docket No. RI76-8

Shell Oil Company
Docket No. RI76-10

APPLICATION FOR REHEARING

Pursuant to Section 19(a) of the Natural Gas Act and Section 1.34 of the Commission's Rules of Practice and Procedure, United Gas Pipe Line Company (United) hereby petitions the Commission for rehearing of its Opinion No. 753 issued in this proceeding on January 30, 1976. In accordance with the aforesaid Section of the Commission's Rules, the following specifications of error are noted:

SPECIFICATIONS OF ERROR

1. The Commission erred in failing to consider whether the interests of the gas consumer require the approval of either alternative contained in the settlement agreement.

2. The Commission erred in failing to consider the price at which the gas would remain in interstate commerce if Williams is successful in terminating the leases in the state court litigation. Williams may be able to qualify for the Opinion No. 699-H rate for all the gas and/or the small producer rate, both of which would be higher than the present effective rates and the rates proposed by the settlement agreement.

3. The Commission erred in failing to find that the public interest, convenience and necessity require the certainty of gas supply that would result from approval of either alternative of the settlement agreement. If the increased

royalty alternative is approved, all the gas will remain committed to United and its customers. If the abandonment alternative is approved, United and its customers would be assured of receiving at least all of the working interests share of the gas. If neither alternative of the settlement is approved, all of the gas, royalty and working interests, could be lost to the interstate market if Williams is successful in terminating the leases and Opinion No. 737, the *Southland Royalty* proceeding, is reversed on appeal.

[484]

4. The Commission erred in holding that the price increases contained in the settlement agreement are not justified in the public interest, convenience and necessity and are not just and reasonable.

5. The Commission erred, after denying price relief, in holding that the less favored alternative of permitting abandonment of the royalty gas does not meet present or future public convenience and necessity.

WHEREFORE, United respectfully requests that the Commission grant rehearing of its Opinion No. 753, and that upon rehearing the Commission grant the relief requested in the applications filed by Pennzoil Producing Company and Shell Oil Company.

Respectfully submitted,

William B. Cassin
Group Vice President and
General Counsel

Phillip D. Endom
Vice President and
Associate General
Counsel

W. O. Crain, Jr.
Lee M. Huber
P. O. Box 1478
Houston, Texas 77001

Donald R. Arnett
1223 Chamber of
Commerce Building
Houston, Texas 77002

By LEE M. HUBER
Lee M. Huber

Attorneys for
United Gas Pipe Line
Company

[495]

UNITED STATES OF AMERICA
FEDERAL POWER COMMISSION

Before Commissioners:
Richard L. Dunham, Chairman;
John H. Holloman III, and James G. Watt.

PENNZOIL PRODUCING COMPANY
Docket No. RI76-8

SHELL OIL COMPANY
Docket No. RI76-10

OPINION NO. 753-A

OPINION AND ORDER DENYING REHEARING

(Issued February 27, 1976)

Pennzoil Producing Company and Shell Oil Company on February 13, 1976, and United Gas Pipe Line Company (United) on February 26, 1976, have filed applications for rehearing of the Commission's Opinion No. 753 and order issued January 30, 1976. The Opinion and order relate to gas produced by Pennzoil and Shell in the Gibson Field, Terrebonne Parish, Louisiana and sold to their customer, United Gas Pipe Line Company. The lessors in the Field, Williams, Inc. and others (Williams), had demanded higher royalties based on the market price for the gas; a civil suit in Louisiana had commenced on the applicability of the market price; and on June 18, 1975, Pennzoil, Shell and Williams had entered into a settlement agreement under which Pennzoil and Shell would apply to the Commission for authority, among other things, to pay a royalty based on a price of 78 cents per Mcf, or alternatively abandon the royalty gas to Williams. Pennzoil and Shell also agreed to pay Williams a surcharge for alleged past underpay-

ment of royalties and proposed to flow through the increased royalties and the surcharge to United.

In its Opinion No. 753 and order the Commission, in adopting the initial decision of the Administrative Law Judge, denied the special relief, the surcharge and the abandonment. Pennzoil and Shell contend that the Commission is in error and, Pennzoil states that, while the settlement agreement was subject to cancellation by February 1, 1976, Williams has agreed that the settlement will not be cancelled before March 1, 1976.

[496]

In the first place Pennzoil contends that the Commission has authority to allow increased rates to reflect royalty payments based on prices in excess of ceiling rates. The Commission said that it was not free to allow royalty costs, which are based on market values, to be passed on to the pipeline as just and reasonable rates. Pennzoil cites *Placid Oil Co.* v. *F.P.C.*, 483 F.2d 880 (CA5, 1973), where the Court said that if producers are put in a bind by their royalty obligations they may petition the F.P.C. for individualized relief, and *Mobil Oil Corp.* v. *F.P.C.*, 417 U.S. 283 (1974), affirming *Placid* and saying that a producer affected by higher royalty obligations is entitled to seek individualized relief. While indicating that relief on some grounds may be possible, this case does not state under what conditions relief should be granted, nor does it define when the right to gain relief matures.

In *F.P.C.* v. *Texaco Inc.*, 417 U.S. 380 (1974), the Commission was instructed to insure "that the rates paid by pipelines, and ultimately borne by the consumers, are just and reasonable" and that "the prevailing price in the market place cannot be the final measure of just and reasonable rates mandated by the Act." While Pennzoil argues here that the price increase is based on a number

of factors, including the risks of the Williams litigation, the propriety of the settlement, and the fact that it is not based on the full market price, it is plain that the royalty is to be based on 78 cents, which is the settlement's reflection of market prices, that are above the area ceiling prices.

The area ceiling prices are intended to be just and reasonable rates. The Commission was upheld in determining just and reasonable rates for the Southern Louisiana area in *Mobil, supra.* The Commission determined just and reasonable national rates in Opinions Nos. 699 and 699-H and was affirmed on appeal.[1] In arriving at the national rates costs of

[497]

production were used and royalties were computed at 16 percent of total costs. (51 FPC at pp. 2272-2273) It is for these reasons that the Commission is not free to allow royalty costs, which are based on market values, to be passed on to the pipelines as just and reasonable rates.

Pennzoil argues that it is an entirely different question when we are dealing with an incremental price that does not generate excessive profits, but *Texaco* says that "a little unlawfulness" is not permitted. In this connection *American Petrofina Company of Texas (Operator), et al.,* FPC, Docket Nos. RI75-17 and RI75-19, issued March 3, 1975, is not in point. In that case the company was given relief because of the costs of additional necessary compression. There was no question of the reasonableness of compression costs or whether they were determined on the basis of lower interstate prices or higher intrastate prices. Nor are the *El Paso Natural Gas Company,* FPC, Docket

[1] *Just and Reasonable National Rates for Sales of Natural Gas from Wells Commenced on or after January 1, 1973,* Opinion No. 699, 51 FPC 2212 (1974); Opinion No. 699-H, FPC ..., Docket No. R-389-B, issued December 4, 1974; *aff'd Sub. Nom. Shell Oil Co.* v. *F.P.C.*, 520 F.2d 1061 (CA5, 1975).

No. RP74-22, *et al.,* orders issued November 29, 1974, and January 29, 1975, in point. In that case the Commission had originally prevented El Paso from collecting a rate increase based on increased royalties which had not yet been paid, but in the cited orders we allowed such rate increases to go into effect subject to refund saying that El Paso had begun paying the increased royalty charges but our review raised a number of issues relating to the justness and reasonableness of the proposed rates that required further consideration by the Commission. Thus in *El Paso* the validity of the increased charges based on royalties was not determined.

Pennzoil further argues that the price increase is just and reasonable, pointing out the risks of the Williams litigation and contending that the gas may be diverted from the interstate market. Pennzoil also notes that no one has contended that the costs involved were improvidently occurred. These considerations are not controlling. The Commission does not have the power to base a part of the regulated price on the unregulated market value of intrastate gas. Pennzoil also objects to the statement that the Commission cannot permit incremental royalty costs resulting from any judgment by a state court from being passed on to a pipeline if the incremental costs are based on any other factors than

[498]

the regulated just and reasonable rate. Pennzoil says that this is dicta and it should be eliminated. Since there is no state court judgment and it is indeed dicta, it will not be necessary to discuss it further at this time. Pennzoil's arguments on the issues of abandonment and surcharge are sufficiently covered in the original opinion, and need not be addressed again.

Shell has listed specifications of error that relate to the discussion of the Administrative Law Judge as well as to our discussion in Opinion No. 753. These matters have largely been covered. Shell contends, *inter alia,* that we have not considered the end result of our decision on the consumer, saying that the gas supply may be lost. The gas supply here that is dedicated to interstate commerce cannot be diverted to intrastate commerce. At the same time, if royalty costs could be based on higher intrastate market values, the impact on the consumer could extend far beyond this case. It is not in the public interest that national rates be distorted in the manner contemplated by Shell, which would create a new species of interstate gas which would rise and fall with intrastate market values.

Also Shell says that the Commission has foreclosed any consideration of the market value royalty problem in any forum and has therefore deprived Shell of its property without due process of law. In this proceeding a hearing was held; the Presiding Judge issued an initial decision to which exceptions were taken; and the Commission considered the issues on the basis of the record. There is no dispute whatever about the facts relating to the computation of the proposed rates based upon market value royalties. Pennzoil, Shell and United have expressed their views, and the Commission determined that special relief should not be granted on the basis of market value royalties. United's contentions are covered by Opinion No. 753 and this Opinion.

The Commission further finds:

The assignments of error and grounds for rehearing of Opinion No. 753 and order in the applications for rehearing filed by Pennzoil, Shell, and United present no facts or legal principles that would warrant any change in or modification of the Commission's Opinion No. 753 and order as supplemented by the above discussion.

[499]

The Commission orders:

The applications for rehearing filed by Pennzoil and Shell on February 13, 1976, and United on February 26, 1976, are denied.

By the Commission.

(Seal)

Kenneth F. Plumb,
Secretary.

[507]

UNITED STATES OF AMERICA FEDERAL POWER COMMISSION

Before Commissioners:
Richard L. Dunham, Chairman;
Don S. Smith, John H. Holloman III,
and James G. Watt.

PENNZOIL PRODUCING COMPANY
Docket No. RI76-8

SHELL OIL COMPANY
Docket No .RI76-10

OPINION NO. 753-B

OPINION AND ORDER DENYING REHEARING AND GRANTING INTERVENTION

(Issued March 26, 1976)

Northwest Pipeline Corporation (Northwest) on February 26, 1976 filed an application for rehearing with respect to the Commission's Opinion No. 753 and order issued January 30, 1976, and on February 27, 1976, filed a petition for leave to intervene. The State of Louisiana on March 1, 1976, also filed an application for rehearing. The nature of this proceeding is described in Opinion No. 753 and Opinion No. 753-A issued February 27, 1976, where the Commission denied applications for rehearing filed by Pennzoil Producing Company, Shell Oil Company and United Gas Pipe Line Company (United). Briefly the lessors in the Gibson Field, Terrebonne Parish, Louisiana, Williams, Inc. and others (Williams) have demanded higher royalties from Pennzoil and Shell based on the market price for the gas, and Pennzoil and Shell, in accordance with a settlement agreement, propose to pass the cost of these royalties on to their customer, United, or alternately abandon the royalty gas to Williams.

Northwest says that it is required to file its petition for leave to intervene as well as its application for rehearing in order to assure that no action is taken by the Commission in these dockets which would prejudice it in *El Paso Natural Gas Co. and Northwest Pipeline Corp.*, Docket No. RP74-23 and *Northwest Pipeline Corp.*, Docket No. RP74-95, or before the Courts in related litigation in *El Paso Natural Gas Co.* v. *Mobil Oil Corp.*, Nos. MO-74-CA-57 (U.S.D.C.W.D. Tex.) where Northwest is a party plaintiff.

[508]

Northwest is concerned with the language of the Commission in Opinion No. 753 that it "cannot permit any incremental royalty costs resulting from this settlement, or resulting from any judgment by a state court regarding royalty payments, to be passed on to the pipeline if these incremental royalty costs are based on any other factors than the regulated just and reasonable rate." As the Commission said, the language insofar as it relates to a court judgment is dicta and it will not be necessary to discuss it further. The Commission however, recognizes Northwest's interest in the proceeding because of its relation to events on its own system and deems it appropriate to grant it intervention.

Louisiana argues that while producer rates under the Natural Gas Act must be just and reasonable, the question is not what a cost should be based on but rather whether the cost incurred was prudent and reasonable when incurred. This matter is covered by our discussion in Opinion Nos. 753 and 753-A. It may be observed that Louisiana quotes *Placid Oil Co.* v. *F.P.C.*, 483 F.2d 880, 911 (CA5-1973), aff'd sub nom *Mobil Oil Corp.* v. *F.P.C.*, 417 U.S. 283 (1974):

> Of course the royalty obligations of the producers are cost components of the rate structure. Any alteration

of this component would necessarily alter the departure point of the rate calculations.

The Court further stated that under *Mobil*[1] this would be a determination of the contract stating the royalty percentage based upon the applicable principles of state law — totally beyond F.P.C. control. The Court, however, added:

> "But we are not willing to alter or stay the implementation of area wide rates for the entire industry merely on the basis of what might happen to some producers' costs if this statement of the law prevails."

It is plain that an allowance for a royalty in an area rate would depend on the royalties generally being paid in the area. This does not mean, however, that an individual producer's rate should be increased because it must pay a higher royalty, particularly one based on market value.

[509]

The Commission further finds:

(1) The assignments of error and grounds for rehearing of Opinion No. 753 and order set forth in the applications for rehearing filed by Northwest and Louisiana present no facts or legal principles that would warrant any change in or modification of the Commission's Opinion No. 753 and order as supplemented by Opinion No. 753-A and this opinion.

(2) It may be in the public interest to allow Northwest to intervene in these proceedings.

The Commission orders:

(A) The applications for rehearing filed by Northwest and Louisiana are denied.

[1] *Mobil Oil Corp.* v. *F.P.C.*, 463 F.2d 256 (CADC-1972); certiorari denied, 406 U.S. 976 (1971).

(B) Northwest is permitted to intervene in the above proceedings subject to the rules and regulations of the Commission: *Provided, however,* that the participation of such intervenor shall be limited to matters affecting asserted rights and interests as specifically set forth in its petition for leave to intervene and that said intervenor take the record as it finds it, and *Provided, further,* that the admission of such intervener shall not be construed as recognition by the Commission that it might be aggrieved because of any order or orders of the Commission entered in these proceedings.

By the Commission.

KENNETH F. PLUMB,
Secretary

(SEAL)

In the United States Court of Appeals for the Fifth Circuit

(Title omitted in printing)

Reference to the Opinion of the Court of Appeals for the Fifth Circuit

(Dated June 6, 1977)

The Opinion of the Court of Appeals for the Fifth Circuit in this case, 553 F. 2d 485 (C.A. 5 1977), has been reproduced as Appendix A in the Petition for a Writ of Certiorari No. 77-648, *Federal Energy Regulatory Commission* v. *Pennzoil Producing Co., et al.*

In the United States Court of Appeals for the Fifth Circuit

(Title omitted in printing)

Reference to the Judgment of the Court of Appeals for the Fifth Circuit

(Dated June 6, 1977)

The Judgment of the Court of Appeals for the Fifth Circuit has been reproduced as Appendix B in the Petition for a Writ of Certiorari No. 77-648, *Federal Energy Regulatory Commission* v. *Pennzoil Producing Co., et al.*

In the United States Court of Appeals for the Fifth Circuit

(Title omitted in printing)

Reference to the Order on Rehearing of the Court of Appeals for the Fifth Circuit

(Dated September 1, 1977)

The Order on Rehearing of the Court of Appeals for the Fifth Circuit, 558 F. 2d 816 (C.A. 5 1977), has been reproduced as Appendix C in the Petition for a Writ of Certiorari No. 77-648, *Federal Energy Regulatory Commission* v. *Pennzoil Producing Co., et al.*

In the Supreme Court of the United States

No. 77-648

FEDERAL ENERGY REGULATORY COMMISSION, PETITIONER

v.

PENNZOIL PRODUCING COMPANY, ET AL.

Order Allowing Certiorari. Filed June 12, 1978

The petition for a writ of certiorari to the United States Court of Appeals for the Fifth Circuit is granted.

Mr. Justice Stewart and Mr. Justice Powell took no part in the consideration or decision of this petition.

U.S. GOVERNMENT PRINTING OFFICE : 1978—O-289-380